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THE FOREIGN TRADE DILEMMA: FACT AND FICTION

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BEFORE THE

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THE FOREIGN TRADE DILEMMA: FACT AND FICTION

TUESDAY, MAY 1, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen.

Also present: Robert R. Davis and Ruth Kurtz, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. I wish to welcome Under Secretary Sprinkel. We appreciate your willingness to testify before the Joint Economic Committee on the dramatic recent changes in the U.S. foreign trade position.

Last year, the foreign trade deficit, as measured by the current account, reached $41 billion. This was nearly three times greater than the previous record deficit by $15 billion in 1978, and the fear is that 1984 will see an even larger shortfall.

The American public is becoming alarmed at these developments, partly because of the magnitude of the numbers, and partly because of the mystery that seems to surround the balance-of-payments issues. The purpose of this hearing is to look into and hopefully solve the mystery and develop a clear view of the current and potential international trade problems that we face. Without a better understanding of trading trends, their causes, and the prospects for future developments, the sheer magnitude of the numbers could provoke an inappropriate policy response that should be avoided.

The so-called twin deficit argument is an example of a policy recommendation gone awry. This erroneous line of reasoning suggests that higher taxes are the solution to perceived trade problems. Supposedly, higher taxes would reduce the budget deficit, lower the value of the dollar, and stimulate exports. The "twin deficit" argument fails to recognize that the value of the dollar is only partly to blame for the foreign trade situation, interest rates are only one of the many factors behind the dollar's strength, and the budget deficit is probably a secondary factor determining the course of interest rates. Moreover, higher taxes would impoverish American workers and businesses, making it harder to compete in world markets.

In a sense we do face a "twin dilemma." First, we must recognize the type of problem we face. Second, we must discover what policies are appropriate and which ones are inappropriate. I sincerely believe

that today's testimony will be of great benefit in this regard and I'm looking forward to all the panel members today. Each and every one of them are distinguished and recognized for their wisdom and experience and expertise in their field.

Under Secretary Sprinkel, it's always good to have you come before this committee. You've been here a number of times, and in the parlance of the Washington, DC establishment, thank you for taking time out of your busy schedule to be here with us this morning.

You may proceed. Your written statement will be entered into the record as if read and you may summarize or proceed any way you do desire.

STATEMENT OF HON. BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. SPRINKEL. Thank you, Senator Jepsen. It's indeed a pleasure to return to the Joint Economic Committee at this time to testify on the U.S. trade deficit and, I might just add, that I fully share your sentiments on the adverse effects of trying to cure a trade deficit with higher taxes.

Measured in the way that it enters our overall balance of payments, the trade deficit grew to $61 billion last year and most forecasters anticipate that will reach $100 billion this year.

Taking into account U.S. trade in both goods and services, as well as transfer payments and receipts, the U.S. current account swung from a surplus of $4.5 billion in 1981 to a deficit of $41 billion, as you indicated, this last year. The swing of the current account deficit reflected the combination of the widening of our trade deficit and a decline in our surplus on net and visible transactions, mainly investment income. While we expect some recovery in investment income, the next year's current account deficit will likely be in the $70 to $80 billion range.

Now such large figures lend themselves to dramatic rhetoric and calls for urgent action. In my remarks today, I will address a number of important issues which need to be borne in mind by the Congress and by the administration in reacting to these requests. These issues include the causes of the widening of our trade deficit, the impacts of the deficit on both the American economy and the rest of the world, and our views on the appropriate policy response.

There have been three major causes of the widening of our trade deficit. These are: The strength and timing of the U.S. economic recovery—it's come up much more rapidly than the rest of the world; declines in our exports to developing countries which are experiencing very serious financial problems; and the appreciation of the dollar on exchange markets over the past 3 years.

Our strong recovery has led to rapid increases in U.S. imports while growth in our major export markets failed to keep pace. As a result, our trade balance with industrialized countries worsened by some $25 billion between 1981 and 1983.

Given all the hue and cry over Japan, one might expect our trade with Japan to have been a major part of this, but in fact, our deficit with Japan only widened by $4 billion, chiefly due to higher U.S. imports.

A ballpark estimate for the direct effect of high U.S. and weak foreign growth on our trade balance is about $15 to $20 billion this year.

Our trade performance with developing countries has been strongly influenced by their debt problems over the past 3 years. Our largest single trade balance deterioration has been with Mexico. U.S. exports to Mexico dropped by half, from $18 billion to $9 billion, between 1981 and 1983, and our balance with Mexico worsened by $12 billion. There was a deterioration of nearly the same size with other non-OPEC developing countries and smaller trade losses with financially troubled countries in Eastern Europe.

In addition, while there is no way to quantify it, LDC debt problems have undoubtedly had an indirect, negative effect on our exports to other industrial countries by lowering their own exports and lowering their real growth. A ballpark estimate of the debt-related part of the widening of our trade deficit would be at least $25 to $30 billion.

Finally, a significant portion of the U.S. trade deficit was attributable to the appreciation of the dollar on foreign exchange markets. Between the beginning of 1981 and this January, the dollar appreciated roughly 30 percent on a weighted-average basis against other major currencies. Although it has since depreciated somewhat, it takes roughly 2 years for the full impact of exchange rate changes to be evident in our trade balance. As a result, the exchange rates driving this year's trade deficit will still be mainly those of 1981–83 when the dollar was appreciating.

While there is general agreement on the direction of the impacts of exchange rate changes on trade flows, it is much more difficult to pinpoint the size of those impacts. There are a number of analytical techniques which can be applied to this issue, which yield, unfortunately, widely differing estimates. Estimates which attribute to dollar appreciation the residual part of the widening of our trade deficit—the part which is not explained by relative growth rates or debt problems—run as low as $25 billion for 1984. But at the high end of the range are estimates from simple econometric models which reach as much as $100 billion. There are substantial technical problems with all methods of performing this calculation and econometric models in particular, have poor track records in predicting the impacts of large shifts in economic variables. The most we can say, I'm sorry to say, with any confidence is that the truth probably lies somewhere in the $25 to $100 billion range, and that's a horribly large range which means we don't know much about the relationship between the exchange rate movement upward and the impact on our exports.

There are many who argue that, regardless of how large or small the impact of dollar appreciation actually is, it has been artificial and unhealthy from their points of view. Thus we are told that the dollar has been driven up unnecessarily by an excessive U.S. budget deficit and high U.S. interest rates. In response, I would point out, that whatever connection one believes there may be between budget deficits and interest rates, in practice there has been very little correlation between interest rates and exchange rates. On balance, over the last 3 years, the dollar appreciated substantially against all major currencies, yet interest rate differentials moved against the dollar. There is a similar pattern in the recent depreciation of the dollar. The dollar has de-

preciated since early January against all major currencies, while interest rate differentials have moved in favor of the United States. Work we have done at Treasury suggests that movements in real interest rates and in real exchange rates are also not closely correlated.

More fundamentally, both the appreciation of the dollar over the past 3 years and its recent moderate depreciation reflect the normal working of the international adjustment process. The major reasons for the appreciation of the dollar over the past 3 years have been: First, fundamentally better U.S. economic performance and prospects on inflation, growth and business profitability; second, weaker performance and prospects in other major industrial countries; and third, safe haven capital flows prompted by economic and political turmoil in the Middle East, Latin America, and Eastern Europe.

Because the strength of the dollar has mainly been the result of our economic successes, there was nothing we should or could have done to keep the dollar from appreciating short of weakening our own economy to match the rest of the world. And that doesn't appeal to me.

Similarly, we see no reason to be concerned about the recent orderly depreciation of the dollar. Several factors which have been pushing the dollar up are now in the process of shifting. International investors may be recognizing that the most rapid and dramatic improvements in the U.S. economy have already happened and that many other industrial countries are beginning slowly to catch up.

Similarly, the historic turnaround in U.S. inflation performance has largely run its course for now, but I hope not forever, as we are entering presently a temporary period of slightly higher inflation rates.

In addition, as some troubled debtor countries come to grips with their problems, capital flight is reduced.

Finally, at some point, currency depreciation in response to a widening current account deficit is a normal part of the international adjustment process. Over time, dollar depreciations should help to moderate both the U.S. trade and current account deficits and foreign surpluses.

Despite occasional assertions to the contrary, a widening U.S. trade deficit has not been an unmitigated disaster for either the United States or for the rest of the world. For each, there are both gains and losses, and trade developments cannot be judged in isolation from other economic developments and policies.

One direct impact of the deficit will be to make output and employment in internationally traded goods industry lower than it would have otherwise been. However, it should be remembered that the widening trade deficit is, to a large extent, an indirect result of our success in cutting inflation and revitalizing the American economy. The benefits of our policies and our noninflationary recovery have helped to offset negative impacts of a bigger trade deficit, not only for the economy as a whole, but also for traded goods industries. Profit reports, stock market results, and productivity and employment gains in U.S. manufacturing industries do not seem to indicate a "deindustrialization" of America.

In addition, for American consumers as a group, there are significant gains from a lower cost of imported goods, which leads directly to lower inflation and increased buying power. Greater foreign competition impacts indirectly on our inflation rate as well, by keeping the pressure on U.S. firms for lower costs, greater efficiency, and lower prices.

Some analysts have complained that the strong dollar and widening trade deficit are causing the current U.S. recovery to be "unbalanced" and therefore unsustainable. Not only was our 6.2-percent real GNP growth rate during 1983 about in line with growth at the same stage of previous recoveries, but the pattern of that growth was healthy. Consumer spending, particularly durables purchases, housing, business investment, and even exports have all made greater contributions to this recovery than in previous ones. Weaker than average contributions came from Federal, State, and local government spending, and from net exports due to the sharp increase in imports.

What is particularly striking is that interest-sensitive categories all made greater-than-average contributions to the recovery—and that business investment, which is so crucial to sustained growth, is one of the leading components. This was apparently still true in the first quarter of this year when real GNP grew at an 8.3-percent annual rate.

For the rest of the world, the impacts of our trade deficit are in many ways a mirror image of impacts on the United States. Trade gains have been a significant factor in helping to solidify the hesitant economic recovery in Europe. In the longer term, improved trade balances in less developed countries are necessary to enable them to service their debt in an orderly manner, and for these improvements to take place, there must inevitably be a counterpart swing toward deficit among their trading partners. Our widening deficit is thus clearly facilitating the economic adjustments which financially troubled developing countries must make to resolve their international debt problems.

As is probably clear by now, we do not believe that the widening trade deficit should precipitate major changes in U.S. economic policy. Many possible U.S. policy changes would be counterproductive. In addition, we believe that forces are already in motion, both through Government policy actions, to strengthen economic performance and manage debt problems, and through the working of the international adjustment process, to address the major causes of our widening deficit.

One set of policy responses which we have consistently rejected is direct action to drive down the dollar's exchange market value. Intervention is not capable of doing so, and imposing capital controls would be a self-destructive act. In fact, we have been working to remove capital controls, which have tended to keep the Japanese yen from fully responding to market forces.

As you know, the Treasury has been involved in a major effort to liberalize the Japanese capital market. I have been chairing a working group, along with Japan's Vice Minister of Finance, Mr. Oba, which is discussing ways to liberalize the Japanese capital markets, so as to create a financial environment in which the yen would more adequately reflect the underlying strength of the Japanese economy.

Our major proposal to the Japanese Government for accomplishing this falls into three categories: Increasing the use of the yen in international transactions; liberalizing Japan's domestic capital market; and increasing market access by foreign financial institutions.

By the conclusion of last month's meeting of the group, our third this year—and there will be additional ones—we had made significant progress on capital market access and liberalization. However, there

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are still major problems with the efforts to internationalize the yen, particularly with our effort to convince the Japanese Government to permit a truly free Euro-yen market. We expect to return on this very central issue very soon.

There have been suggestions that a massive tax increase is needed to eliminate the trade deficit. I suppose such an action could have a significant and immediate impact if it were to drive the U.S. economy into a steep recession, but I don't think that's exactly what the proponents have in mind. They are operating from the presumption that our Federal budget deficit is the primary reason for the widening trade deficit, a presumption which I have challenged in my earlier analysis.

However, the administration is working with the Congress, in a bipartisan way, to reduce the budget deficit in a manner which will not otherwise harm the U.S. economy. The primary cause of the budget problem has been excessive growth of Government spending, and expenditure restraints should be the primary means of addressing the problem. Currently we are working with the Congress on a balanced package of expenditure and revenue measures. For the longer term, President Reagan has proposed other initiatives, including a balanced budget amendment, line-item veto authority, and structural changes in our system of taxation.

There have been proposals over the past year to "correct" the U.S. trade deficit and to modify the impact of foreign competition on U.S. industries, by restricting foreign access to the U.S. market or by subsidizing U.S. exports. We are strongly opposed to such protectionist responses.

Protectionism can have serious negative impacts on the U.S. economy through a general increase in inflation, higher prices to industries dependent on the protected imports, and the risk that the countries affected by the imports restraints will retaliate. In the absence of retaliation, protectionist measures tend to produce further dollar appreciation which would offset their intended positive impact on the trade balance.

Finally, measures of this type by the United States would cut the ground from under our efforts to restrain protectionism by other countries and deal a serious blow to the noninflationary world recovery that's now developing.

Agricultural exports are very important to U.S. trade, accounting for roughly 20 percent of our total exports. They are crucial to the American farmer as well, since exports account for about 40 percent of the total crop receipts by the American farmers, and over 50 percent for several major crops.

This administration is very concerned about the impacts of market restrictions and foreign export subsidies on U.S. exports of agricultural products. We have just recently succeeded in getting increased access for U.S. beef and citrus to the Japanese market. In reaction to foreign subsidies, we have subsidized U.S. exports of agricultural products to some individual markets, such as Egypt, to emphasize that our patience is wearing thin, and are working both bilaterally with the European Community, and multilaterally in the GATT, to get these subsidies removed.

We are prepared to continue selected subsidies as necessary, and we hope it isn't necessary. However, we do not see a need for broad export subsidies for all U.S. exports to "offset" the impact of the strong dollar. Such subsidies would be extremely costly to the Treasury at a time when we need to sharply reduce Government expenditures. They could spur foreign imposition of countervailing duties and they could set off an escalation of disruptive competition that would benefit no one and cost all of us.

In conclusion, Mr. Chairman, I would argue that we are already doing everything that can profitably be done, to deal with the trade situation. We are encouraging other countries, developed and developing, to get their own houses in order, and we are continuing our efforts to strengthen U.S. economic policies and performance, including a determined effort to reduce future budget deficits in a balanced and responsible manner.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Sprinkel, together with attached tables, follows:]

Prepared Statement of Hon. Beryl W. Sprinkel

Mr. Chairman, Senators, Congressmen, it is a pleasure for me to appear before this Committee to discuss the U.S. trade deficit. This is a complex topic on which views can differ substantially, and I am under no illusions that every observer would agree with the Administration's policy approaches in this area. However, our policies are grounded in the facts, and I would like to share our analysis with you today.

There has, of course, been a substantial widening of the trade deficit. Measured in the way that it enters our overall balance of payments, the trade deficit averaged $30 billion per year from 1977 to 1982. Last year it grew to $61 billion, and most forecasts suggest it will reach about $100 billion this year (Table 1).

Geographically, this widening of our trade deficit has been fairly widespread (Table 2). Given the hue and cry about Japanese exports, one would expect to find that our trade deficit with Japan was a leading cause of the widening of our trade deficit. In fact, our deficit with Japan only widened by $4 billion between 1981 and 1983, mainly due to higher U.S. imports. That is, while access for U.S. goods to the Japanese market is not all we would like it to be, there has not been a major deterioration in U.S. export performance with Japan.

U.S. trade with other industrial countries has not held up as well as our trade with Japan. Since 1981, our exports to these countries have fallen $15 billion, and our trade balance with them has swung from a $13 billion surplus to an $8 billion deficit last year.

By far the largest U.S. trade balance deterioration has been with Mexico. Our exports to Mexico have dropped by roughly half since 1981, from $18 billion to $9 billion last year. With rising U.S. imports, our balance with Mexico swung from a $4 billion 1981 surplus to a deficit of $8 billion last year. Adding in smaller declines with other less developed countries, our overall trade balance with non-OPEC LDCs worsened by $22 billion from 1981 to 1983.

Bucking the tide was our trade with OPEC member countries. Driven by forces set in motion by OPEC itself, oil consumption in the United States and other oil-importing countries has continued to plummet, helping to drive down oil prices. The combined impact of these forces has helped trade balances in all oil-importing countries -- particularly the United States. U.S. imports from OPEC dropped by half, from $50 billion in 1981 to $25 bilion last year. While OPEC in turn had to cut back its imports from the United States by $6 billion, the net impact on our trade balance was still positive by $19 billion.

Trade performance by commodity group has fewer surprises (Table 3). U.S. oil imports dropped by $24 billion from 1981 to 1983. Other imports, which had fallen in the 1982 recession, grew strongly during our 1983 recovery and stood $19-1/2 above their 1981 level. Our exports, in contrast, continued to fall on a yearover-year basis. Agricultural exports in 1983 stood $7-1/2 billion below their 1981 peak, and non-agricultural exports were down $29-1/2 billion.

Export markets are highly important to the health of U.S. agriculture, and agricultural exports are also a major component of total U.S. exports. They account for roughly 20 percent of total exports, and for 40 percent of the crop receipts of American farmers. For several major commodities, exports account for over 50 percent of crop receipts.

Taking into account U.S. trade in both goods and services, as well as transfer payments and receipts, the U.S. current account swung from a surplus of $4-1/2 billion in 1981 to a $41 billion deficit last year (Table 3). In addition to the $32-1/2 billion widening of our trade deficit over this period, there was a $1-1/2 billion increase in net U.S. transfer payments abroad and an $11 billion decline in our surplus on net service transactions. This decline came almost entirely through reduced net income on our overseas investments. While we expect some recovery in investment income, next year's current account deficit will likely be in the $70 to $80 billion range.

These are very large figures, both in absolute terms and as a percentage of our Gross National Product. They lend themselves to dramatic rhetoric and calls for urgent action. In my remarks today, I will address a number of important issues which need to be borne in mind by the Congress and by the Administration in reacting to these requests. These issues include the causes of the widening of our trade deficit, the impacts of the deficit on both the American economy and the rest of the world, and our views on the appropriate policy response.

The Causes of a Widening Trade Deficit

In broad terms, there have been three major factors in the widening of our trade deficit. These are: the strength and timing of the U.S. economic recovery; declines in our exports to developing countries which are experiencing financial problems; and the appreciation of the dollar on exchange markets over the past three years. Table 4 gives rough orders of magnitude for the impact of each of these factors.

In the United States, the trough of the last recession came late in 1982. During 1983, our real GNP expanded 6.2 percent -- a strong rebound, and about in line with the first year of other recoveries in the postwar era. Real growth in other major industrial countries, in contrast, was only 3 percent last year, and even by the end of the year a sustained upturn was not yet underway in some of those countries. Signs are that a strong U.S. recovery is persisting into 1984, as reflected in the current Administration forecast of 5 percent real growth, while economic recovery will continue to gather steam in most of the major foreign industrial countries this year.

In qualitative terms, the impact of the relatively strong U.S. cyclical position on our trade balance is quite clear: our strong recovery is leading directly to rapid increases in U.S. imports, while growth in our major export markets fails to keep pace. A ballpark estimate for the "growth gap" in our trade balance is $15 to $20 billion this year.

A slow recovery in the industrial world has not been the only problem for U.S. export markets. We are also a major exporter to developing countries -- and our trade performance has been strongly influenced by their debt problems over the past two years. The inability of these countries to finance previous levels of imports was the major reason for the 50 percent drop in U.S. exports to Mexico from 1981 to 1983, which I cited earlier, and for the $22 billion deterioration in our trade balance with all non-OPEC LDCs. Similar financial problems in Eastern Europe were reflected in a $1-1/2 billion decline in U.S. exports to that region, as well. Finally, while there is no way to quantify it, LDC debt problems have undoubtedly had an indirect negative effect on our exports to other industrial countries, by lowering their own exports and real growth. Overall, a ballpark estimate of the debt-related part of the widening of our trade deficit would be at least $25 to $30 billion.

Finally, a significant portion of the U.S. trade deficit was also attributable to the appreciation of the dollar on foreign exchange markets. Between the beginning of 1981 and this January, the dollar appreciated roughly 30 percent on a weighted-average basis against other major currencies. Although it has since depreciated somewhat, it takes roughly two years for the full impact of exchange rate changes to be evident in our trade balance. As a result, the exchange rates driving this year's trade deficit

will still be mainly those of 1981-1983, when the dollar was appreciating.

Dollar appreciation, to the extent it is not offset by relatively better U.S. inflation performance or other factors which improve our competitiveness, makes it more difficult for U.S. businesses to compete with foreign firms. This is true both in our domestic market, where foreign goods become cheaper for U.S. consumers, and in our export markets, where dollar-priced goods become more expensive in terms of the local currency.

While there is general agreement on the direction of the impacts of exchange rate changes on trade flows, it is much more difficult to pinpoint the size of those impacts. There are a number of analytical techniques which can be applied to this issue, which yield significantly different estimates, and in addition small changes in the application of a given technique can produce large changes in the result. Estimates which attribute to dollar appreciation the residual art of the widening of our trade deficit -- the part which is not explained by relative growth rates or debt problems -- run as low as $25 billion for 1984. At the high end of the range are estimates from simple econometric models which reach as much as $100 billion. There are substantial technical problems with all methods of performing this calculation, and econometric models in particular have poor track records in predicting the impacts of large shifts in economic variables. The most we can say with any confidence is that the truth probably lies in the $25 to $100 billion range.

Exchange Rate Developments

There are many who would argue that, regardless of how large or small the impact of dollar appreciation actually is, it has been artificial and unhealthy. Thus, we are told that the dollar has been driven up unnecessarily by an excessive U.S. budget deficit and high U.S. interest rates. We are offered precise calculations of the degree to which the dollar is "overvalued" -- figures typically ranging from 20 to 30 percent.

On balance over the last three years, the dollar appreciated substantially against all major currencies -- yet interest rate differentials moved against the dollar. Between the beginning of 1981 and the end of last year:

-- the dollar appreciated by 38 percent against the German mark, 83 percent against the French franc, and 14 percent against the Japanese yen;

-- while interest rate differentials moved against dollar assets, by 5 percentage points for Germany, over 9 percentage points for France, and nearly 6 percentage points for Japan.

There is a similar pattern in the recent depreciation of the dollar. Since its mid-January peak, the dollar has dropped against all other major currencies, while interest rate differentials have moved in favor of the United States.

A more meaningful economic argument can be made linking high real interest rate differentials with a strong dollar. It is notoriously difficult to measure real interest rates, given the central role played by inflation expectations in determining the real interest rates perceived by investors. Work we have done at Treasury suggests that there has been little correlation between movements in real interest rates and real exchange rates. However, all such empirical work is very sensitive to the means chosen to approximate expected inflation rates in the United States and the other major industrial countries, and it is possible to obtain a wide variety of differing estimates.

More fundamentally, both the appreciation of the dollar over the past three years, and its recent depreciation, reflect the normal working of the international adjustment process. The concept that the dollar has become "overvalued" is intuitively appealing, but a poor guide to economic policy. Most estimates of the degree of dollar "overvaluation" are based on the assumption that the exchange rate between any two countries should move only to offset differing national inflation rates, so as to keep the international price-competitiveness of traded goods unchanged.

Decades of economic research, however, have failed to verify this simplistic "purchasing power parity" theory of exchange rate determination. This should not be too surprising, since it is only designed to explain one dimension of the behavior of merchandise trade -- which in turn is only a small part of total international transactions. The vast bulk of transactions in the foreign exchange markets are capital transactions, and the dynamics of the foreign exchange market reflect that fact.

International investors act on their perceptions of where real after tax rates of return to capital will be highest, and they constantly weigh the relative attractiveness of assets denominated in different currencies. Thus, when investors sense that there are current or prospective developments which will significantly alter relative rates of return to capital, they react accordingly. Over time, the resulting international capital flows help to achieve a more efficient allocation of resources.

The major factors influencing market perceptions of real rates of return to capital over the past three years have been: fundamentally better U.S. economic performance and prospects; weaker performance and prospects in other major industrial countries; and the threat posed by economic and political turmoil in the Middle East, Latin America, and Eastern Europe. Our economic program brought a historic turnaround in U.S. inflation performance, followed by vigorous recovery. As a result of our non-inflationary recovery, deregulation, and more favorable depreciation allowances under the Economic Recovery Tax Act of 1981, the profitability of

American business investment has improved dramatically. Foreign economic prospects and business conditions, especially in Europe, did not keep pace with ours. And in many troubled parts of the globe, concerns over possible expropriation, capital controls, or physical destruction of assets led to "safe haven" capital flows into the world's strongest and most stable country.

Under those circumstances, there was nothing we should -- or could -- have done to keep the dollar from appreciating, short of weakening our own economy to match the rest of the world. Similarly, we see no reason to be concerned about the recent orderly depreciation of the dollar. Several of the factors which have been pushing the dollar up are now shifting. International investors may be recognizing that the most rapid and dramatic improvements in the U.S. economy have already happened, and that many other industrial countries are catching up. Similarly, the historic turnaround in U.S. inflation performance has largely run its course for now, and we are entering a temporary period of slightly higher inflation rates. Finally, at some point currency depreciation in response to a widening current account deficit is a normal part of the international adjustment process. Over time, dollar depreciation should help to moderate both the U.S. trade and current account deficits and foreign surpluses.

Impacts on the U.S. and Global Economy

Despite occasional assertions to the contrary, a widening U.S. trade deficit has not been an unmitigated disaster for either the United States or for the rest of the world. For each there are both gains and losses, and trade developments cannot be judged in isolation from other economic developments and policies.

In the United States, there can be no question that firms in our traded-goods industries are finding life more difficult. Particularly as a result of dollar appreciation, they must cut costs (and in some cases profit margins) in order to compete with foreign goods in both our domestic market and in markets overseas. One result may be that the direct impact of the deficit will be to make output and employment in these industries lower than it otherwise might have been. However, it should be remembered that the widening trade deficit is, to a large extent, an indirect result of our success in cutting inflation and revitalizing the American economy. The benefits of our policies and our non-inflationary recovery have helped to offset negative impacts of a bigger trade deficit, not only for the economy as a whole but also for traded-goods industries. Profit reports, stock market results, and productivity and employment gains in U.S. manufacturing industries do not seem to indicate a "deindustrialization" of America.

In addition, for American consumers as a group there are significant gains from a lower cost of imported goods, which leads directly to lower inflation and increased real buying power. Greater foreign competition impacts indirectly on our inflation rate, as well, by keeping the pressure on U.S. firms for lower costs, greater efficiency, and lower prices. Service industries,

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which compete primarily for domestic sales against other U.S. firms, reap the benefits of lower inflation and thus tend to have rising output and employment.

Some analysts have complained that the strong dollar and widening trade deficit are causing the current U.S. recovery to be "unbalanced" and therefore unsustainable. I don't think the facts support this claim. As indicated in Table 5, not only was our 6.2 percent real GNP growth rate during 1983 about in line with growth at the same stage of previous recoveries, but the pattern of that growth was healthy. Consumer spending (particularly durables purchases), housing, business investment, and even exports all made greater contributions to this recovery than in previous ones. Weaker than average contributions came from Federal, state and local government spending and from net exports.

What is particularly striking is that interest-sensitive categories all made greater-than-average contributions to the recovery -- and that business investment, which is so crucial to sustained growth, is booming most of all. So far this year, strong growth is continuing, as indicated by the 8.3 percent real GNP growth rate for the first quarter -- and all signs are that fixed investment is still a leading component.

For the rest of the world, the impacts of our trade deficit are in many ways a mirror image of impacts on the United States. Traded goods industries in other countries gain output and employment; there is also a temporary upward pressure on foreign inflation rates from higher import costs. Trade gains with the United States have been a significant factor in helping to solidify the hesitant economic recovery in Europe. In the longer term, improved trade balances in less developed countries are necessary to enable them to service their debt in an orderly manner, and for these improvements to take place there must inevitably be a counterpart swing towards deficit among their trading partners. Our widening deficit is thus clearly facilitating the economic adjustments which financially troubled developing countries must make to resolve their international debt problems.

The charge is sometimes made that a large U.S. trade and current account deficit causes the United States to "drain capital" out of the rest of the world, thereby damaging other countries. In balance of payments accounting, it is undeniably true that a current account deficit must be parallelled by transactions of equal size, and opposite sign, elsewhere in the balance of payments. These parallel transactions are usually thought of as being capital transactions, so that a U.S. current account deficit by definition would mean there is also a net capital inflow to the United States.

There are a number of fundamental problems with the "draining capital" accusation, however. The first is the influence of the statistical discrepancy, as clearly reflected in U.S. capital account data for 1982 (Table 6). Our 1982 current account deficit of $11 billion might have implied an $11 billion net capital inflow, if there were no statistical discrepancy in our balance of payments.

However, in fact there was a recorded net capital outflow of $30 billion in 1982, and the accounts were balanced by a positive statistical discrepancy of $41 billion. By definition, we do not know what sorts of transactions contributed to the discrepancy -- and while the possibilities for measurement error and reporting gaps are probably greatest in the capital account, the existence of a large discrepancy casts some doubt on all of our balance of payments data.

A second basic flaw in the "draining capital" argument can be seen in the 1983 data. Last year the statistical discrepancy was rather small ($7 billion), so our $41 billion current account deficit was reflected mainly in recorded net capital inflows, totaling $34 billion. However, the 1982-83 swing from net capital outflows to net inflows was not the result of higher inflows of foreign capital to the United States: these inflows actually fell by $5 billion, from $88 billion in 1982 to $83 billion last year. What caused a net inflow was that outflows of U.S. capital fell by even more -- by $69 billion. U.S. investors, and particularly U.S. banks, reduced their foreign lending dramatically, while foreigners also invested somewhat less in the United States.

The third flaw is the issue of causation. Since the balance of payments must, by definition, balance, a current account deficit can only occur in conjunction with a net capital inflow (disregarding the significant problem of the statistical discrepancy). However, one cannot legitimately say that the current account deficit "caused" the capital inflow. It would be just as easy to say that increased demand for U.S. dollar assets, as reflected in the capital account, has forced us to run a current account deficit. The fact is that all of the transactions recorded in our balance of payments accounts are simultaneous reflections of U.S. and foreign economic conditions, in the ways I have discussed earlier.

The U.S. Policy Response

As is probably clear by now, we do not believe that the widening trade deficit should precipitate major changes in U.S. economic policy. Some of the measures which are urged on us are impractical or even counterproductive. In addition, we believe that forces are already in motion -- both through government policy actions to strengthen foreign economic performance and manage debt problems, and through the working of the international adjustment process -- to address the major causes of our widening deficit.

One set of policy responses which we have consistently rejected is direct action to drive down the dollar's exchange market value. As was demonstrated by the thorough international study of foreign exchange market intervention carried out between the Versailles and Williamsburg Summits, intervention does not have a significant or lasting impact on exchange rates. Attempts to use intervention to permanently alter exchange rate levels are doomed to failure.

If intervention sales or purchases are done in such a way that they are permitted to alter the course of domestic monetary policy -- that is, if they are "unsterilized" in the technical jargon -- they can have a lasting impact. However, this can be a misleading way of looking at what is really going on in such a case: the factor which would alter exchange rate behavior would be that there had been a change in monetary policy, not that it had taken place in connection with intervention. There is no doubt that we could drive down the dollar very rapidly by reigniting rapid inflation through excessive money growth -- but I cannot seriously believe that the American people want to undo all we have done to bring inflation under control and revitalize our economy. Furthermore, while we would quickly reap the disastrous results of excessive monetary expansion in our domestic economy, the positive effects of dollar depreciation on our trade balance could take roughly two years to reach their full extent, as I noted earlier.

Some observers have suggested that we use capital controls to force down the dollar. I suspect even the proponents recognize that imposing capital controls would be a self-destructive act, and are only suggesting them for dramatic effect. In brief, I would note that capital controls the United States has tried to use in the past have not worked particularly well. More fundamentally, to the extent that new U.S. controls did work they would have major negative impacts on domestic and international capital markets, could lead to interest-rate increases and sectoral credit shortages, and would undermine the longer-term confidence of international investors in the U.S. dollar as a transactions currency and the U.S. economy as a place to invest.

In the case of the Japanese yen, we have been working hard to remove capital market restrictions and imperfections which we believe tend to keep the yen from fully reflecting market forces. Last month, along with Japan's Vice Minister of Finance Tomomitsu Oba, I chaired the third meeting of the Ad Hoc Working Group which has been working to liberalize the Japanese capital market. We have discussed a wide range of issues, relating mainly to ways to increase the use of the yen in international transactions, to liberalize Japan's domestic capital market, and to increase market access by foreign financial institutions. Through these changes, we are hoping that the financial linkages between Japan and the rest of the world can be strengthened and the yen put in a position to reflect more adequately the underlying strength of the Japanese economy.

By the conclusion of last month's meeting, we had made significant progress on capital market access and liberalization. However, there are still major problems with the effort to internationalize the yen -- particularly with our effort to convince the Japanese government to permit a truly free Euro-yen market. This is a central issue, to which we expect to return in the near future.

There have been suggestions that a massive tax increase is needed to eliminate the trade deficit. I suppose such an action could have a significant and immediate impact if it were to drive the U.S. economy into a steep recession -- but I don't think that's exactly what the proponents have in mind. They are operating from the presumption that our Federal budget deficit is the primary reason for the widening trade deficit, a presumption which I have challenged in my earlier analysis.

However, the Administration is working with the Congress, in a bipartisan way, to reduce the budget deficit in a manner which will not otherwise harm the American economy. The primary cause of the large budget deficit is excessive growth of Federal spending, and the primary means of reducing the budget deficit should be expenditure restraint. Currently we are working with the Congress on a balanced three-year package of expenditure and revenue measures. For the longer-term, President Reagan has proposed other initiatives, including a balanced budget amendment, line-item veto authority, and structural changes in our system of taxation.

There have been proposals over the past year to "correct" the U.S. trade deficit, and to modify the impact of foreign competition on U.S. industries, by restricting foreign access to the U.S. market or by subsidizing U.S. exports.

Protectionism is not cost-free by any means. Its drawbacks are clear and well known to you, so I will only summarize them briefly. Protectionism can have a serious impact on other sectors of the U.S. economy by increasing the overall inflation rate, raising input prices for industries dependent on the protected imports, and risking that foreign countries affected by U.S. import restraints will retaliate.

In addition, import surcharges, quotas, tariffs, or export subsidies would likely be offset by further dollar appreciation which would offset their intended trade-balance impacts. Some measures of this type can yield temporary gains for specific industries or firms, but only at the cost of offsetting losses to other U.S. industries and firms. Finally, I would note that such measures by the United States would cut the ground from under our efforts to restrain protectionism by other countries. A generalized increase in protectionism would deal a serious blow to the non-inflationary world recovery now developing. The urgency of avoiding further protectionism, and of renewed liberalization of the trading system, was a major theme of last month's IMF Interim Committee meetings here in Washington.

U.S. industries do have a legitimate right to seek redress from unfair foreign practices such as the use of subsidies benefitting exports and foreign dumping. This Administration will continue to actively enforce our trade laws, as cases are brought to us.

I would like to note that this Administration is very concerned about the impacts of market restrictions and foreign export subsidies on U.S. exports of agricultural products. We have just

recently succeeded in getting increased access to the Japanese market for U.S. beef and citrus to Japan. In reaction to foreign subsidies, we have directly subsidized U.S. exports of agricultural products to some individual markets such as Egypt to emphasize that our patience is wearing thin, and are working both bilaterally with the European Community and multilaterally within the GATT to get these subsidies removed. We are prepared to continue selected subsidies, as necessary, to keep their attention.

However, we do not see a need for broad export subsidies for all U.S. exports, to "offset" the impact of the strong dollar. Such subsidies would be extremely costly to the Treasury at a time when we need to sharply reduce Government expenditures. They could spur foreign imposition of countervailing duties. And they could set off an escalation of disruptive competition among nations to subsidize their exports, which in the end would cancel one another out with no net benefit to any exporting country.

In conclusion, I would urge the Congress to resist pressures to respond to the widening of our trade deficit with measures which would be harmful to our own broader national welfare. While it is unfortunate that impacts of increased competitive pressures from foreign goods are not always as evenly distributed among our citizens as are the benefits of our non-inflationary recovery, we must remember that the deficit is, to a large extent, an indirect result of our success in revitalizing the American economy.

As economic recovery abroad catches up with our own, as developing countries come more fully to grips with their debt problems, and as the international adjustment process brings an exchange market response to diverging external positions among the major industrial countries, we expect the deficit to begin declining again over time. In addition, where there are restrictions on access by U.S. firms to foreign markets for goods, services, or capital, we will continue to press for a more open system.

Table 1

U.S. Trade Balance, 1977-1984*
($ Billions)

	1977-1982 Average	1982	1983	1984**
Exports	187	211	200	210
Imports	-217	-248	-261	-310
Balance	-30	- 36	-61	-100

* Trade data on balance of payments basis.
** Treasury projection for 1984.

Table 2

Shifts in U.S. Trade by
Country or Country Group, 1981-1983*
($ Billion)

	1981	1983	Shift
Trade with Mexico:			
U.S. Exports	18.2	9.1	-9.1
U.S. Imports	-13.8	-16.8	-3.0
Balance	4.4	-7.7	-12.1
Trade with Other non-OPEC LDCs:*			
U.S. Exports	49.7	46.4	- 3.3
U.S. Imports	-53.1	-60.4	- 7.3
Balance	- 3.5	-14.1	-10.6
Trade with Japan:			
U.S. Exports	21.8	21.7	-0.1
U.S. Imports	-37.6	-41.3	-3.7
Balance	-15.8	-19.6	-3.8
Trade with Other Industrial Countries:			
U.S. Exports	120.1	105.3	-14.8
U.S. Imports	-106.7	-113.0	- 6.3
Balance	13.4	-7.8	-21.1
Trade with East Europe			
U.S. Exports	4.4	2.9	- 1.5
U.S. Imports	- 1.6	- 1.4	0.2
Balance	2.9	1.5	- 1.3
Trade with OPEC			
U.S. Exports	21.1	15.1	- 5.9
U.S. Imports	- 49.9	- 25.2	24.7
Balance	- 28.8	- 10.0	18.8

*All data on balance of payments basis, except trade with "other non-OPEC LDCs" which is on roughly-comparable Census Customs-value basis.

TABLE 3

U.S. Trade and Current Account Balances, 1981-1983
($ Billion)

		1981	1983	Shift
Exports:	Agricultural	44.0	36.6	- 7.4
	Non-Agricultural	193.0	163.6	-29.4
Imports:	Oil	- 77.8	- 53.8	24.0
	Non-Oil	-187.3	-206.9	-19.7
TRADE BALANCE		- 28.1	- 60.6	-32.5
Net Investment Income		33.5	23.6	- 9.9
Other Net Services		6.1	4.8	- 1.3
Net Transfers		-6.9	- 8.6	- 1.7
NET INVISIBLES		32.7	19.8	-12.9
CURRENT ACCOUNT BALANCE		4.6	- 40.8	-45.4

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Table 4

Shifts in U.S. Trade Balance, 1981-1984
($ Billion; Balance of Payments Signs)

	1981	1984	Change
Exports	237	210	- 27
Oil Imports	- 78	- 60	+ 18
Non-Oil Imports	-187	-250	- 63
TRADE BALANCE	- 28	-100	- 72
Trade Balance Excluding Oil Imports	50	- 40	- 90

Estimates of Contributions to Shift in Trade Balance:

U.S. Cyclical Position	-15 to -20
International Debt Problem	-25 to -30
Dollar Appreciation	-25 to -100

Table 5

THE BALANCED NATURE OF THE CURRENT EXPANSION

As the table shows, the current expansion has been remarkably well balanced, rather than distorted by high interest rates as some had feared. Above-normal gains have been made in the interest-sensitive areas of spending on consumer durables such as autos and appliances, as well as in business capital spending and housing. The trade balance has been weak but exports have risen rather than remaining flat as in the first year of the average of previous expansions.

Distribution of Real GNP Growth During
the First Year of Expansion
(as percent of total)

	Average of five previous expansions	Current expansion
Consumer Spending	52.3	57.3
Durables	19.3	24.0
Business Capital Spending	7.6	21.9
Housing	15.2	16.6
Inventories	26.4	34.2
Federal Purchases	-2.8	-8.7
State and Local Purchases	7.5	0.8
Net Exports	-6.0	-21.9
Exports	0.6	4.5
Imports	-6.4	-26.5
Memo: Total growth in real GNP in percent	6.8	6.2

Table 6

U.S. Capital Account, 1982-1983
($ Billion)

	1982	1983
Recorded Inflows of Foreign Capital to U.S.	88	83
minus		
Recorded Flows of U.S. Capital to Other Countries	-118	- 49
equals		
Net Recorded Capital	- 30	34
plus		
Statistical Discrepancy	41	7
equals		
Net Recorded Capital plus Discrepancy	11	41
Current Account Deficit	-11	-41

Senator JEPSEN. Thank you, Mr. Sprinkel.

Just by way of a general summary, is this an accurate statement with regard to your testimony: The widening trade deficit has not been a disaster for the United States or for the rest of the world: the strong dollar, in a manner of speaking, is a vote of confidence in the U.S. policy?

Mr. SPRINKEL. Yes, sir; I believe that. If you will remember back some years when inflation was accelerating into double-digit territory and threatening to go higher, we had a very weak dollar and certain companies and industries found marvelous opportunities to export which they exploited. But very few would argue that we should go back to sharp acceleration in inflation and thereby to a weak dollar,, simply because it would have certain benefits on the export side. It would have lots of disadvantages. We should recognize, in addition, as you indicated in your comment, that there are some pluses as well as some minuses from our trade deficit. One is that it has spurred recovery abroad. If our exports are to rise, the most important way that this can occur is by getting strong economic performance among our trading partners, and that, fortunately, is beginning to happen.

So I don't think it's been a disaster. I think there are some major benefits, but I do believe market adjustment, and we expect markets to continue adjusting.

Senator JEPSEN. To follow along and further summarize and put the frame around what you have said, even though there is some stress in export industries, we should not panic on the policy side; foreign exchange controls will not work and tax increases will destroy competitiveness. So we must weather a gradual equilibrium process in external accounts that is already beginning. Is that also accurate?

Mr. SPRINKEL. Yes, sir. The last time we tried foreign exchange controls, which was back in the 1960's, they had significant adverse effects. The Eurodollar market started in London and most of it is still there. Furthermore, after some adjustment, it was possible to evade the controls. We believe in the efficacy of free markets and we do not plan to go down the road of imposing the very controls that we are trying to get removed in Japan and I hope also in a few countries in Western Europe.

Senator JEPSEN. Along those lines, then, and in that spirit, with that admonition, do we have some danger of overreacting with the proposed legislation that is currently being pushed by a number of groups on the Hill to bring out and pass domestic content?

Mr. SPRINKEL. I think it's a very serious threat. It certainly would lead to a serious misallocation of resources around the world. It would take competitive pressures off of certain companies. It would cost the American consumer, and it wouldn't correct the problem.

Therefore, I certainly urge the Congress to recognize that markets are adjusting. They are free to adjust. We are trying to make them freer, not only in the United States but elsewhere. It would be very counterproductive for us to start down that road because almost certainly the rest of the world would follow—at least the important parts of the world with whom we trade.

Senator JEPSEN. Based on your experience and your observations, is it that 20 percent that you said the agricultural economy played in our exports that is the first to be hurt if we develop that type of protectionist policy?

Mr. SPRINKEL. I think that's correct because we are such a major force in that market. If they want to get back at us in an effective way, they would try to destroy some of the markets where we have been successful and agriculture is the one that comes first to mind.

Senator JEPSEN. In the bigger picture, outside of the direct negative impact that it would have on our farmers' bank accounts and on our agriculture, in the big picture of the economy of this country, is it also correct that in the balance of trade payments, the largest contribution on the plus side comes from agricultural exports; is that correct?

Mr. SPRINKEL. Yes, sir; that is correct.

Senator JEPSEN. So it is not just the agricultural community itself that would feel the devastating impact of this type of quantum leap in protectionism, but it would dramatically affect the entire economic balance of activities?

Mr. SPRINKEL. Yes, it would. In the short run it would lead to further deterioration of our trade balance.

Senator JEPSEN. All right. Then how should we approach the trade problems? Going from generals to specifics, should we work on a worldwide approach? I experience along with my colleagues the same type of interaction that we have when we talk about controlling Federal spending. Everybody says, "Yes, let's hold the line, but you've got to understand that in my area we've got special problems and you can't cut too much back in our area; in fact, we probably need a little adjustment upward," and I find in the protectionism area—not totally—but I find a little bit of that comes into play when people say, "Well, we are all for free and open trade and we've got to have it and it's good for our economy, but, of course, you've got to understand that in the interest of national security and in the interest of our people, if we could just put a little extra barrier or a little extra tab on our particular product, I think it will all work out and it will benefit us."

Mr. SPRINKEL. Well, I understand a lot of the arguments made. I was in business for 28½ years in banking, and there's a great tendency to say, "Competition is marvelous for everybody except me and I have a special problem and therefore I need a little help." But if you start down that road, they will all be special problems and we will all lose in the end.

So I think it's up to Congress and the administration to try to resist these understandable pressures. Some of the companies and some of the industries have very serious and real problems, but, fortunately, many of them are not arguing for protection for their companies and their industries.

Senator JEPSEN. Would you recommend a worldwide approach to working and negotiating in order to resolve these things or would it be better to try to resolve these issues one at a time bilaterally?

Mr. SPRINKEL. Well, I think my own feeling is that we should try to work on both fronts. We have been working with the Japanese bilaterally recently with some success, both in the goods area and the capital markets area. We are supportive of the Japanese who have been out front asking for another GATT round. When the proposals were first made some months back, there were quite general adverse reactions, I would say, but that attitude around the world is changing, certainly in the developed countries. Therefore, we do support, with careful prior work, another effort to improve the GATT rules, to include services for example, and to try to encourage some countries

to subscribe to the GATT rules which are not presently subscribing to them.

I think we should work on all those fronts and, of course, at the same time, try to encourage the kinds of economic policies which are likely to lead to strength abroad. Recovery is important since protectionist pressures tend to grow during periods of weak economic activity, and even in the early phase of a recovery because they still remember what happened to them 1 year ago.

I have been very pleased at the extent to which other governments—especially developing countries—are getting inflation rates under better control and encouraging investments and encouraging job creation. Some of them have some very serious problems. Western Europe, the EEC, for example, to my amazement, has lost jobs over the last decade—not much, but over a half million or so, and certainly no job creation whatsoever. Their unemployment rates are very high. We, in the meantime, have created about 17 million jobs. And I think a lot of that is due to rigidities within their economies. They do not have flexible economies and they are now beginning to recognize that. As they move to try to remove some of the rigidities, they too can prosper.

So that I think we need to work both bilaterally and multilaterally on both the trade front and the broad economic policy front, and that's what we are trying to do.

Senator JEPSEN. Along that line, despite the current trade deficit and trade problems, do you continue to see export trade as an important factor, if not the most important factor, in economic growth and job creation?

Mr. SPRINKEL. Yes, that certainly has been true over the last decade or so. We had a year or so when there was not much improvement, but we have had a growing trend toward a higher percentage of our total production going to international trade and I see no reason to believe that will be reversed, provided we do not go down the protectionist road and lead most of the rest of the world with us. They would follow. There is just no doubt. If we can hang firmly on the freer trade stance, I think we will be successful in holding off the worst efforts abroad.

Senator JEPSEN. I would like to talk about the strength of the dollar and examine that issue a little bit with you. The critics of the Reaganomics and the economic recovery and the national renewal that has taken place talk about the strength of the dollar overseas being—and in the agricultural community especially—the cause for a lot of the problems. They forget about things like the grain embargo and other things that have also contributed—not solely but contributed. The strength of the dollar, they say, now is due to the interest rates. They weave in that in 1984, at the present time, the present administration is responsible for the high interest rates and the strength of the dollar is somewhat due to that.

Rather than saying that, you don't hear the arguments often enough that I think you have woven into your remarks, and that is that the dollar is strong due to a strong U.S. economy and low inflation, No. 1. The dollar is strong, No. 2, due to weak policies abroad. And the dollar is strong, No. 3—and one that has hardly ever been touched on and, unfortunately, isn't appreciated by a large number of folks as I would

like to see in this country—and that is, our U.S. political stability—money coming in here from other countries that people send here because, for themselves and their families, they feel that it's safe. They know we do things with ballots rather than bullets. They know that we don't survive and roll over and capitulate or self-annihilate or self-destruct. Those things are all positive things. That doesn't make our problems less severe or go away, but if we are going to address it or try to resolve it, I think we must approach it with that insight and perception. Do you agree?

Mr. SPRINKEL. Yes, sir. I agree fully. I can understand the arguments about interest rates and the strong dollar and intuitively it sounds sensible. I have the disadvantage of having been born in the great State of Missouri and they have a motto down there that says, you've got to show me. I listen to the arguments but then I go look at the numbers. We've spent a lot of time at Treasury looking at those numbers in terms of interest rate spreads vis-a-vis other important markets, both in nominal terms and in real terms, and we cannot find a consistent relation between either the level of interest rates in the United States or the spread between U.S. interest rates and those abroad and the strength of the dollar.

Since the facts are not consistent with that argument, then it seems to me it's time to look at other things that have happened in the United States. By far, one of the important ones was getting our inflation rate down. People had come to believe that it was just going to go up, up, up because it had done so for a decade and a half. Well, there's a little doubt out there now and I hope a lot more doubt as the years go by.

Senator JEPSEN. It would help a lot if we could get the general public to understand this. As you well understand, in 1984, I'm going to have access to a lot of surveys in this election year and the majority of the people in this country do not understand or perceive the fact that inflation has changed.

Mr. SPRINKEL. Right.

Senator JEPSEN. Whose job is that, by way of education, and how do we get that point across? At the same time, I have people that you would call solid business people who come up and say, "You know, let's loosen up on this policy here. What's the matter with a little 13-percent inflation? At least a lot of people were making money." I say, "Yes, but we had 21.5-percent interest rates back here. The national average was about 22 or 23." And they say, "Oh, yes, I forgot about that."

But the lack of understanding—if you're going to get anybody to appreciate something and therefore put some type of value on it or therefore take action, either physically or emotionally or psychologically, they've got to understand what it is; and people in this country—the majority of them, according to all national surveys I've seen—quite a few—still do not realize that inflation, compared to what it was, is flat on the deck and has been there for quite a while, and what that means in terms of extra purchasing power.

Mr. SPRINKEL. Well, it's very important. I don't think exhortations from an administration is the prime way to convince them, although we do that. We try to point out the important progress that has been made.

What I think has to be done is to continue to perform, keep the inflation rate down, and eventually expectations adjust. Now they have adjusted downward, but not nearly as much. I saw a survey just yesterday reporting that survey of industrial managers that indicated the inflation rate over, I believe it was the next decade, would be 6.5 percent. Well, they may be right, but I certainly hope they are wrong. We have been below 6.5 percent for a long time and if we can keep it down there, I expect gradually the marketplace will continue to move.

One other point I wanted to make with respect to policies that have improved the dollar, one was inflation that I just talked about, but the other is that I think we have made a major improvement in the rate of after-tax return on investment in the United States. Otherwise, I cannot explain why capital investment did not weaken as much in the last recession as typically, why it turned up sooner in the recovery than typically, and why it is moving upward much more rapidly in this period of the last 15 months or so than is typical of other prior recoveries, despite the fact that interest rates are extremely high.

So it isn't just the interest rate. That's important and we want to get it down by reducing inflation expectations, but we have succeeded through our tax adjustments in improving the after-tax rates of return both to savers and investors. This will have the effect of encouraging capital formation which over time will certainly raise standards of living and create jobs. I think it would be very foolish, based on some theory that's not supported very well by the data, to go back and reverse that process and say, "Well, we'll get interest rates down by killing investment and making it unprofitable."

We want to maintain profitability of investment so we can have jobs and higher standards of living.

Senator JEPSEN. Well, we could go on for long time. If you have any additional comments for the record, it will be kept open, and I would appreciate you submitting them.

Assuming that we are entering an adjustment period for the value of the dollar and eventually the trade deficit—and I believe it is improving and it's a fundamental improvement that's having its effects—do you have any idea how long you might expect the process of returning to trade balance to take? Optimally, how long should the adjustment time be?

Mr. SPRINKEL. Well, it's going to be years, not months, unfortunately. Even if the dollar were to continue downward, the lag for the adjustment process tends to be 1½ or 2 years to have the full effect. But then, of course, it also depends on how rapid the recovery is abroad. If there are improvements in foreign growth, our exports can benefit from them.

But I think we can see no improvement in our trade balance this year. It's going to deteriorate based on what's happened in prior years. But hopefully, beginning in 1985 or 1986, we can begin to see the adjustment process yield results. It will be a few years before we get back to the kinds of trade arrangements that we had before difficulties began in terms of growth abroad, in terms of difficulty in Latin America, and, of course, the strength of the dollar which has also adversely affected some of our exports. So I think we have to be patient, and that's very difficult. The tendency is to rush out and do something and sometimes that is highly counterproductive.

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Senator JEPSEN. The next panel is going to address, among other things, some of the duties of GATT and talk about negotiations, and they will probably touch on the European Economic Community as well as Japan. You said that we've got to do both, have a worldwide approach to this negotiation as well as a bilateral one. In other words, we've just got to be active and be out there punching and swinging.

Mr. SPRINKEL. Yes, sir.

Senator JEPSEN. Specifically, in agriculture again, do you believe there's enough worldwide concern about agricultural trade to gain an international commitment to lessening trade tensions in this sector? The string is stretched pretty tight with our European Economic Community, especially when we've had this much movement. Thanks to some longtime negotiations and to a lot of work by a lot of folks, on the 27th of April, an agricultural initiative was announced just last week with Japan. Some people would call it tokenism, but as I reminded one of the critics I was visiting with shorty after this was announced and we were discussing how it affected the State of Iowa, with the relaxation of tariffs on the hayballers and so forth, we want to do more and we want to do better, but, boy, this is sure the right direction. Regardless of the size of the step, it's a step in the right direction.

I remember what happened to the switchboard in my office when the textile talks, the rumor was—and a rumor was what it turned out to be—the rumor was that they broke down, and then the cages started being rattling about tariffs and soybeans coming into play and the soybean farmers and the Soybean Association and the agricultural folks really said, "What are you doing with those textile talks?" Because the first thing I believe that was brought up, just by way of conversation, by China was the mention of the word, among other things, soybeans, which is a pretty freely traded and very key exported agricultural commodity.

So if you have any words of wisdom by way of direction or counsel by way of action that we might pursue or take to move off the dime the European Economic Community and other negotiations that can be made, I would appreciate having them.

Mr. SPRINKEL. Well, we do have problems with the EEC in agriculture, as you know. Fortunately, it's costing them a lot of money and they are having great difficulty financing their agricultural policy. Hopefully, as a result of this difficulty, there will be some reductions—we can't be sure—in the subsidies that are provided for agricultural products in EEC.

I have sympathy to the concerns of the farmer because I spent a third of my life on a farm. But the thing we can do to help the most, in my opinion, is to avoid going down the protectionist route because any retaliatory action abroad almost certainly will hit very hard in the area where we are relatively efficient, that is, agricultural production. So I think we have to keep doing what we have been trying to do.

Senator JEPSEN. I think it's sad testimony, too, on our Yankee history, our Yankee creativity, our ability to be productive. There's a thought sometimes—at least it's crossed my mind—why don't we roll up our sleeves and take off all of these support things and let's produce and let's put it on the world market and show them just where the real breadbasket is and what we can do? That's not going to happen, I guess.

Mr. SPRINKEL. It doesn't look like it.

Senator JEPSEN. But we are going to have to be thinking and planning of moving in that direction. The period of having farm policies that support production for storage instead of stomachs has been counterproductive.

Mr. SPRINKEL. I agree.

Senator JEPSEN. I thank you very kindly. Do you have any closing statements?

Mr. SPRINKEL. No, sir; I do not. I thank you very much for inviting me. I'm pleased to come back to the Joint Economic Committee.

Senator JEPSEN. Thank you.

The next panel will consist of Mr. Jan Tumlir and Mr. Robert Heller. Mr. Tumlir is visiting professor at UCLA and chief economist for the General Agreements on Tariffs and Trade; and Robert Heller is vice president of international economics at Bank of America.

I welcome both of you to the Joint Economic Committee and I would advise you that your written statements will be entered into the record as if read and you may proceed in any way you so desire. We will start with Mr. Jan Tumlir. You may proceed.

STATEMENT OF JAN TUMLIR, VISITING PROFESSOR OF ECONOMICS, UCLA, AND CHIEF ECONOMIST FOR THE GENERAL AGREEMENTS ON TARIFFS AND TRADE [GATT]

Mr. TUMLIR. Thank you, Senator. Thank you also for the honor of inviting me here to give this testimony.

I would like to say a few words about the deficit and then a few words on the trade situation.

It seems to me that what distinguishes this recovery from the previous ones is that it is occurring at an unusually low level of net national savings. What is happening is that the investment opportunities the economy is generating attract capital from abroad, and that is the only noninflationary way in which these investment opportunities can be financed. The foreign capital supplementing inadequate domestic savings must therefore bring real resources and these can enter only through a current account deficit. That is why I do not consider the deficit as such a problem in itself. I have already seen calculations showing how many more employed or fewer unemployed we could have without the external deficit, but these are clearly wishful and irrelevant calculations, because without the deficit, we would have more inflation, shorter recovery, and more unemployment.

The important point to keep in mind is that the level of saving—more exactly, the savings ratio—has in fact declined globally, to a point where we can speak of a relative shortage of capital throughout the world economy. In the 1970's, public budget deficits, offsetting private savings, grew everywhere in absolute amounts as well as in relation to national products. The inflationary wave of that period seems also to have reduced the household savings ratio in most industrial countries. Last, but not least, in 1981, the current account surplus of the OPEC group, which had formerly provided a substantial addition to global savings, was drawn down and a growing deficit has taken its place since. These countries, as a group, now draw on their reserves accumulated abroad.

It is this growing shortage of genuine savings that brought on the international debt crisis 2 years ago. The rise of the dollar exchange rate and of interest rates internationally, indeed the ensuing U.S. recession itself, should properly be viewed as a systemic reaction terminating the clearly unsustainable process of declining saving and increasing lending for progressively less productive purposes. What we are seeing now is national economies competing for a shrunken volume of investible capital in the only way that counts: By the attractiveness of the investment opportunities they can generate.

As regards foreign trade, the totals of exports and imports, and above all, the conditions under which they are transacted, have a far more important and enduring influence on the trading economies than the temporary net surpluses or deficits. Let me begin with an issue that may not be immediately obvious but is fundamental.

It is mainly foreign trade that connects national economies and their price systems into a world market and an international price system. That international price system is, in normal conditions, an efficient information-processing mechanism. It promptly signals incipient scarcities and surpluses anywhere in the world economy. From these signals, firms in all countries can form expectations and begin to plan their adjustment. The important point is that tariffs as such do not interfere with this price information mechanism but quantitative restrictions paralyze it in their areas of application.

The fact is that a very large proportion of foreign trade today is under quantitative control and restriction. Centrally planned economies account for some 10 percent of agricultural products is under some form of quantitative, or at any rate nontariff, restriction. Commodity price maintenance schemes are being managed or negotiated for a range of tropical agricultural products and other raw materials such as tin. Crude oil is certainly not traded on open market terms. A detailed, comprehensive scheme governs exports of textiles and clothing from developing countries and Japan to other developed countries. The arrangements for trade in steel are beginning to resemble an international cartel. Exports of automobiles from the world's most efficient producer are restrained in most Western countries. Similar restraints proliferate in consumer electronics and, most recently, they also began to appear in machine tools, especially numerically controlled and automatic and robotic type machines.

It seems to me that when industrial firms are prevented from obtaining the best equipment at international prices, protectionism can be said to have entered its overtly suicidal phrase. This is only an incomplete list of restrictions. One would also have to describe, at similar length, the widespread practice of subsidization in foreign trade as another source of price rigidity and distortion.

Furthermore, the damage which this system does to the international price system is still understated by any enumeration of particular measures in force because most of the recent restraints are discriminatory. They usually affect only a particular trade flow in a given category—usually, the trade flow from the cheapest source. Their presence, however, causes all remaining trade in that category, even though it is technically free, to be conducted at distorted prices, and the consequent impairment of the international and thereby every

nation's price system is now so extensive that one may be justified in asking: What remains?

Without reliable guidance by the price system, business investment planning becomes prone to error, uncertainties multiply, investment and adjustment slow down. Let me give you just a few examples of the uncertainty that these measures generate and compound. When so many prices are prevented from finding their own proper levels but the exchange rates are free, it is not surprising that the exchange rates tend to move erratically. With the price system so extensively impaired, there simply is not enough information to make possible a smooth adjustment of the exchange rates to purchasing power parities. So unpredictable exchange rate movements become another potent source of business uncertainty.

The trend toward more protectionism is another source of uncertainty. When protection can be obtained easily and trade restrictions multiply, firms will continue to export from existing facilities but it would be highly imprudent to invest in new production facilities for export. It is also worth noting that the uncertainties about future access to markets contributed significantly to the emergence of the international debt problem. In the borrowing countries, the highest yield investment opportunities would be, in a world of stable trade arrangements, in the sectors producing exportable goods. But the risk of rising protection made these investments unattractive and, invested in production for the home market, the borrowed capital could not earn its own debt service.

Consider, finally, the effect of protection on the protected economies. Already the expression, "protected economies," is incorrect, for no economy can be protected across the board, on the net, so to speak. Protection is only a redistributive device. It redistributes resources and profits and manpower among industries. Only industries receiving protection of more than average incidence actually benefit; all others must lose. And the most important among the losers are the export industries. It is an old proposition in economics that "a tax on imports is a tax on exports," because protection given to other industries raises the costs of production in general and therefore also the cost of production of exports, but the exporters remain price-takers on international markets. They are thus squeezed between stable prices and rising costs; and, in addition, as imports decline, foreign demand for exports is reduced as well.

Now I think that the steep rise in the level of uncertainty throughout the world economy is still insufficiently appreciated as a cause of the halting economic growth and increased instability we have been experiencing in recent years. It would seem to follow that if it were possible merely to arrest, in a believable way, the spread of protectionism, the state of the world economy would improve and the current expansion of the American economy would become more secure. It follows further that a generalized winding down of the existing restrictions would have a net stimulative effect, not just on the world economy at large, but on each of the national economies engaging in the exercise.

I would like to mention one special problem of the forms of trade restrictions currently used. Contemporary protectionism operates

mainly through bilaterally negotiated export restraints. This form of protection not only implies additional economic costs for both the importing and exporting countries, but portends dangerous political consequences as well. When the importing country imposes nondiscriminatory protection at its own borders, foreign exporters continue to compete and sell at their cost-price which is below—and usually considerably below—the wholesale price prevailing in the now restricted import market. At least the importing country, if not the consumer, obtains its imports at the lowest possible price. If protection is by tariff, the difference between the import price at the border and the domestic wholesale price becomes government revenue. If the protection is by global quota, the price difference increases the profits of the importers. But when exporters themselves restrict their sales, the difference goes to them. They can, in other words, sell at or close to the wholesale price prevailing in the restricted market. In this sense, the foreign export industry and its government may be said to be bribed into the restraint agreement.

The Japanese Economic Journal put out a calculation recently which showed that whereas the U.S. automobile industry made $6.3 billion pre-tax profit last year, the Japanese automobile exporters, whose share of the U.S. market is less than a quarter, only about 23 percent, realized $3.5 billion profit on their sales to the United States alone. So the restraint has been highly profitable to them.

Now the point is that to be able to control its exports and collect the export rents, however, the foreign industry must cartelize itself. That is to say, its leading firms must agree among themselves about market shares, and its government then enforces cartel discipline through the issue of export licenses. When we conclude an export restraint agreement on the same product—say, steel—with two or three or more countries, allocating a share of our market to each of them, their industries do not have to compete with each other for sales to the United States. They may agree on joint strategies in third markets as well. At the limit, in a comprehensive arrangement such as that governing trade in textiles and clothing, each exporting country will have a fixed share in the market of each importing country and the whole world market will be divided up and it will be closed to newcomers and the newcomers at this stage will be the poorest developing countries for which textiles and clothing would be the most logical place to start on their road to industrialization.

Historically, we have wanted our industry, as well as industry abroad, to be organized on the basis of competition. Competition is not only more efficient but also safer because it disperses both political and economic power. Cartels are power formations, dangerous because they tend to acquire influence on national policy. We, as well as the European Community, find ourselves in the paradoxical position of preaching competition and actively promoting cartels abroad. We have one large establishment enforcing competition at home, and another large bureaucracy, the trade policy establishment, stopping it at the border.

There is really no easy or speedy or certain way to arrest the erosion of the liberal international trade regime that has contributed so much to the world's prosperity in the post-World War II period. The long-run policy objective should, in my view, be to secure as firmer anchor-

ing in the national law of the major trading countries of the international rules by which they have agreed to govern their trade policies. It is not that national legislation in any country mandates policies that contravene these international agreements; but it is sometimes worded loosely enough to permit such contravening policies. Furthermore, given the present degree of tension and friction in international economic policy, it seems to me to be most difficult for any government to change the course of policy development on its own, acting individually. It seems to me that an international gesture is needed through which a number of governments could support each other. But that, in turn, means that any radical reform is not possible because there are limits to what domestically hard-pressed governments can agree upon internationally. Nonetheless, we have to begin somewhere.

What would seem to me a feasible and promising gesture of this kind would be a binding reaffirmation by the major trading countries of the principle of unconditional most-favored-nation treatment as a basis of their trade policy. It can be easily made obvious to all that in this principle, national interest and international responsibility perfectly coincide. Indeed, I would say that if we cannot agree with our main trading partners on the desirability of nondiscrimination, there is not much else that we could hope to agree upon. Yet if it were reasserted with conviction and with legislative backing, the principle would soon reveal its—today, I think, unsuspected—reach and strength. Such an act could reasonably be considered to represent the beginning of a consolidation.

It would, if not perhaps terminate, certainly much reduce the practice of restraining trade by agreements from the export side. It would do so by making it difficult for the government of the exporting country to agree to, and for the government of the importing country to demand, that kind of arrangement. As a result, competition would be promoted throughout the world economy, accelerating adjustment in all countries. At the same time, our painful antitrust dilemma would disappear.

Now let me emphasize that an agreement of this kind would not require a dismantling of quantitative restrictions. Those necessitated by special national situations and justifiable under the existing international rules could remain in use, provided they were administered in a nondiscrimination way. There is a way in which quantitative restrictions can be administered without any discrimination. It consists of consolidating the existing market-sharing arrangements into a single global quota and offering the licenses to import under it for sale in a public auction. In this way, the export or import rents—the difference between the import price at the border and the domestic wholesale price—would again be captured for public revenue. The fact that virtually all governments are at this time wrestling with difficult budgetary problems offers another reason for believing that an initiative of this kind might be of interest to them, and thus negotiable. Another consequence would be that the prices established for import licenses would indicate quite precisely what the margins and costs of protection were, something we do not know under the present arrangements. The additional information would substantially improve the quality of our political discussion.

Once the main cause of erosion of the liberal international trade order, the bilateral export restraint, was contained by agreement, other contentious issues of international trade policy would, I believe, become easier to deal with.

Thank you.

[The prepared statement of Mr. Tumlir follows:]

PREPARED STATEMENT OF JAN TUMLIR

The question to be discussed today is thoughtfully worded. My summary answer to it is that foreign trade represents a grave policy dilemma that can only be resolved by bold diplomacy, willing and able to pledge substantive changes in national conduct of trade policy; but that the deficit in the current account of our balance of payments is essentially temporary and not a problem in itself. I intend to concentrate on foreign trade but allow me to begin with a few remarks on the deficit.

Current Account Deficit and Global Savings

The word cyclical refers to changes induced by the regular ups and downs in business activity and the deficit is largely, though not entirely, cyclical in this sense. The United States economy is virtually alone among its O.E.C.D. partners in undergoing a vigorous recovery. In most previous recoveries, however, the economy maintained its current account surplus. What distinguishes this recovery, and actually explains the deficit, is that the upswing is occurring at an unusually low level of net national saving. The investment opportunities the economy is generating attract capital from abroad, which is the only non-inflationary way in which they can be financed. The investment is real. The foreign capital supplementing inadequate domestic savings must therefore bring real resources and these can enter only through a current account

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deficit. That is why I do not consider the deficit a problem in itself. I have already seen calculations showing how many more employed or fewer unemployed we could have without the external deficit but these are clearly wishful and irrelevant calculations. Without the deficit we would have more inflation, shorter recovery and more unemployment.

The level of saving, more exactly the savings ratio, has in fact declined globally, to a point where we can speak of a relative shortage of capital throughout the world economy. In the 1970's, public budget deficits, offsetting private saving, grew everywhere in absolute amounts as well as in relation to national products. The inflationary wave of that period seems also to have reduced the household savings ratio in most industrial countries. Last but not least, in 1981, the current account surplus of the OPEC group, which had formerly provided a substantial addition to global savings, was drawn down and a growing deficit has taken its place since as these countries, as a group, now draw on their reserves accumulated abroad.

It is this growing shortage of genuine savings that brought on the international debt crisis two years ago. The rise of the dollar exchange rate, and of interest rates internationally, indeed the ensuing United States recession itself, should be properly viewed as a systemic reaction terminating the clearly unsustainable process of declining saving and increasing lending for progressively less productive purposes. What we are seeing now is national economies competing for a shrunken volume of investible capital in the only way that counts: by the attractiveness of the investment opportunities they can generate.

Foreign Trade, the Price System and Uncertainty

The totals of exports and imports, and above all the conditions under which they are transacted, have a far more important and enduring influence on the trading economies than the temporary net surpluses or deficits. Let me begin with an issue which is not immediately obvious but fundamental.

It is mainly foreign trade that connects national economies and their price systems into a world market and an international price system. That price system is, in normal conditions, an efficient information processing mechanism. It promptly signals incipient scarcities and surpluses anywhere in the world economy. From these signals, firms in all countries can form expectations and begin to plan their adjustment. Tariffs do not interfere with this price/information mechanism but quantitative restrictions paralyze it in their areas of application.

The fact is that a very large proportion of foreign trade is today under quantitative control and restriction. Centrally planned economies account for some ten percent of world trade. The bulk of trade in temperate zone agricultural products is under some form of quantitative, or at any rate non-tariff, restriction. Commodity price-maintenance schemes are being managed or negotiated for a range of tropical products and other raw materials such as tin. Crude oil is certainly not traded on open market terms. A detailed, comprehensive scheme governs exports of textiles and clothing from developing countries and Japan to other developed countries. The arrangements for trade in steel are beginning to resemble an international cartel. Exports of automobiles from the world's most efficient producer are restrained in most Western countries. Similar restraints proliferate in consumer electronics and most recently, they

began to appear also in machine tools. When industrial firms are prevented from obtaining the best equipment at international prices, protectionism can be said to have entered its overtly suicidal phase. This is only an incomplete list of restrictions; one would also have to describe, at similar length, the widespread practice of subsidization in foreign trade as another source of price rigidity and distortion.

Note also that the damage to the price system is understated by any enumeration of particular measures in force. Most of the recent restraints are discriminatory. They usually affect only a particular trade flow in a given product category (typically, the flow from the cheapest source). Their presence, however, causes all remaining trade in that category, even though it is technically free, to be conducted at distorted prices. The consequent impairment of the price system is now so extensive that one may be justified in asking: what remains?

Without reliable guidance by the price system, business investment planning becomes prone to error, uncertainties multiply, investment and adjustment slow down. Let me give a few examples of the uncertainty that measures of this kind generate and compound. When so many prices are prevented from finding their own proper levels but the exchange rates are free, is it surprising that the latter tend to move erratically? With the price system so extensively impaired, there simply is not enough information to make possible a smooth adjustment of exchange rates to purchasing power parities. So unpredictable exchange rate movements become another potent source of uncertainty.

The protectionist trend itself is another. When protection can be obtained easily and trade restrictions multiply, firms will continue to export from existing

facilities but it would be imprudent to invest in new facilities for export production. It is estimated that in the 'golden quarter century' between 1948 and 1973, between one-fifth and one-third of all industrial investment in the O.E.C.D. countries was undertaken with a view to exporting. It is also worth noting that the uncertainty about future access to markets contributed significantly to the emergence of the international debt problem. In the borrowing countries, the highest-yield investment opportunities would be, in a world of stable trade arrangements, in the sectors producing exportable goods. The risk of rising protection made these investments unattractive and, invested in production for the home market, the borrowed capital could not earn its own debt service.

Consider, finally, the effect of protection on the protected economies. Already the expression "protected economies" is incorrect, for no economy can be protected across-the-board, on the net. Protection is only a redistributive device, redistributing resources and profits among industries. Only industries receiving protection of more than average incidence actually benefit; all others must lose. Most important among the losers are the export industries. It is an old proposition in economics that "a tax on imports is a tax on exports." Protection given to other industries raises the costs of export production while the exporters remain price-takers on international markets; in addition, as imports decline, foreign demand for exports is reduced as well. When the economy has adjusted to increased protection, imports and exports are invariably seen to have declined together relative to national product. Now the export industries know this. The machine tool industry knows that steel protection is raising its costs and reducing its foreign market; so when demands for protection grow everywhere, it must fear not only protection

abroad but at home as well. Its investment plans will reflect both kinds of uncertainty.

It is generally the case that a country's import-competing industries show lower-than-average, and export industries higher-than-average, labor productivity. Tying resources in the former and impeding the expansion of the latter, protection consequently slows down the growth of labor productivity (that is, income) in the economy at large. The effects of protection on jobs are better understood when we think in terms of families rather than individuals. Saving a father's job in a declining industry will make it more difficult for his better educated son to find an adequate job in the technologically more demanding sectors of the economy.

The steep rise in the level of uncertainty throughout the world economy is still insufficiently appreciated as a cause of the halting growth and increased instability. It could be compared to a thick fog descending on a turnpike, slowing down traffic and causing accidents. The uncertainty emanates from different sources and I have tried to show here that the contribution made to it by trade policy has been substantial. It would seem to follow that, if it were possible merely to arrest, in a believable way, the spread of protectionism, the state of the world economy would improve and the current expansion of the American economy would become more secure. What I have said about the redistributive effects of protection, and the damage it causes to the price system, implies that a generalized winding down of the existing restrictions would have a net stimulative effect, not just on the world economy at large, but on each of the national economies engaging in the exercise.

Export Restraints and Antitrust Law

Contemporary protectionism operates mainly through bilaterally negotiated export restraints. This form of protection not only implies additional economic costs for both the importing and exporting country but portends dangerous political consequences as well. When the importing country imposes non-discriminatory protection at its own borders, foreign exporters continue to compete and sell at their cost-price which is below the wholesale price prevailing in the now restricted import market. At least the importing country, if not the consumer, obtains its imports at the lowest possible price. If protection is by tariff, the difference between the import price at the border and the domestic wholesale price becomes government revenue. If protection is by a global quota, the price difference increases the profits of importers. But when exporters themselves restrict their sales, the difference goes to them -- they can, in other words, sell at or close to the wholesale price prevailing in the restricted market. In this sense, the foreign export industry and its government may be said to be bribed into the restraint agreement.

To be able to control its exports and collect the export rents, however, the foreign industry must cartelize itself. Its leading firms must agree among themselves about market shares. Its government then enforces cartel discipline through the issue of export licenses. When we conclude an export restraint agreement on the same product with two or more countries, allocating a share of our market to each, their industries do not have to compete with each other for sales to the United States. They may agree on joint strategies in third markets as well. At the limit, in a comprehensive arrangement such as that governing trade in textiles and clothing, each exporting country will have a fixed share in the market of each importing country and the

world market as such will be closed to newcomers, the poorest developing countries for which textiles and clothing would be the logical first step on their road to industrialization.

Historically, we have wanted our industry, as well as industry abroad, to be organized on the basis of competition. Competition is not only more efficient but also safer because it disperses economic and political power. Cartels are power formations, dangerous because they tend to acquire influence on national policy. We, as well as the European Community, find ourselves in the paradoxical position of preaching competition and actively promoting cartels abroad. We have one large bureaucracy enforcing competition at home and another, the trade policy establishment, stopping it at the border. They seem to be mainly making work for each other, taking in each other's washing.

The trouble goes deeper. Our antitrust law prohibits any restraint on competition in domestic and foreign commerce, and particularly restraints in the form of comprehensive industrial combinations and cartels. There are precedents of proceedings in our courts against foreign cartels and the Supreme Court confirming the judgments. In a 1927 opinion, Justice Stone said: "Indeed the major premise of the Sherman Act is that the suppression of competition in foreign trade is in and of itself a public injury; or at any rate, that such suppression is a greater price than we want to pay for the benefit it sometimes secures." This doctrine has never been repudiated and there are signs in various decisions of the last ten or fifteen years that our courts are beginning to be uneasy about the situation as it is developing. The uneasiness focuses on the acceptability of 'foreign sovereign compulsion' as a defense argument in cases of complaints about cartelization of our import supply. It would be manifestly unjust to

prosecute foreign firms for acts compelled by their government. But what if the plaintiffs could prove that the foreign government acted on urgent diplomatic invitation by the Executive Branch of the Government of the United States? I am not a lawyer and cannot say. But I think it deserves your attention that a major premise of the antitrust law, which has decisively shaped our economy and polity for close to a century, seems to be undergoing an unanticipated change.

The Aims of Policy

There is no easy or speedy or certain way to arrest the erosion of the liberal international trade regime that has contributed so much to the world's prosperity in the post-World War II period. The long run policy objective should be to secure a firmer anchoring in the national law of the major trading countries of the international rules by which they have agreed to govern their trade policies. It is not that national legislation in any country mandates policies that contravene these international agreements; but it is sometimes worded loosely enough to permit such policies. Given the present degree of tension and friction in international economic policy, it is also most difficult for any government to change course on its own, acting individually. An international gesture is needed in which a number of governments would support each other. But that in turn means that any radical reform is unliely; there are limits to what domestically hard pressed governments can agree upon internationally. Nonetheless, we have to begin somewhere.

What would seem to me a feasible and promising gesture of this kind would be a binding reaffirmation by the major trading countries of the principle of unconditional most-favored-nation treatment as a basis of their trade policy. It can be easily made obvious to all that in this principle national interest and international responsibility perfectly coincide. Indeed, if we cannot agree with our main trading partners on the desirability of non-discrimination, there is not much else that we could hope to agree upon. Yet if it were reasserted with conviction and legislative backing, the principle would soon reveal its -- today I think unsuspected -- reach and strength. Such an act could reasonably be considered to represent the beginning of a consolidation.

It would, if not perhaps terminate, certainly much reduce the practice of restraining trade from the export side. It would do so by making it difficult for the government of the exporting country to agree to, and for the government of the importing country to demand, such arrangements. As a result, competition would be promoted throughout the world economy, accelerating adjustment in all countries. At the same time, our painful antitrust dilemma would disappear.

Let me emphasize that an agreement of this kind would not require a dismantling of quantitative restrictions. Those necessitated by special national situations and justifiable under the existing rules could remain in use, provided they were administered in a non-discriminatory way. There is a way in which quantitative restrictions can be administered without any discrimination. It consists of consolidating the existing market-sharing arrangements into a single global quota and offering the licenses to import under it for sale in a public auction. In this way, the export or import rents -- the difference between the import price at the border and the domestic wholesale price --

would again be captured for public revenue. The fact that virtually all governments are at this time wrestling with difficult budgetary problems offers another reason for believing that an initiative of this kind might be of interest to them, and negotiable. Another consequence would be that the prices established for import licenses would indicate quite precisely what the margins and costs of protection were, something we do not know under the present arrangements. The additional information would substantially improve the quality of our political discussion.

Once the main cause of erosion of the liberal international trade order, the bilateral export restraint, was contained by agreement, other contentious issues of international trade policy would become easier to deal with. Eventually a general movement of reciprocal trade liberalization might be induced on the scale of that from which all countries benefited in the 1950's and 1960's.

Senator JEPSEN. Thank you. Mr. Heller, you may proceed.

STATEMENT OF H. ROBERT HELLER, VICE PRESIDENT FOR INTERNATIONAL ECONOMICS, BANK OF AMERICA N.T. & S.A.

Mr. HELLER. Thank you very much, Mr. Chairman.

The rapidly rising U.S. trade deficit has reached record proportions in recent months. Therefore, it is important to ascertain whether the trade deficits will be reversed automatically over the course of the business cycle or whether structural factors will lead to a continued worsening of the situation. These questions are important because they have a direct impact on the viability of the recovery and will influence the available policy options.

Some observers blame the large U.S. trade deficit on the strength of the U.S. recovery and high U.S. interest rates. By this, they stress the cyclical causes of the trade deficit. While these factors are certainly of some importance, they do not tell the whole story. A good argument can be made—and indeed has been made this morning—that structural influences are at least as important in causing the rising trade deficits.

It should also be borne in mind that while the trade imbalance has a physical or real dimension to it, the financial flows provide much of the linkages and feedback effects between the trade deficits and the total economy and are therefore important to an analysis of the trade situation.

In particular, the Government budget deficit will have to be financed either by a foreign capital inflow or an excess of domestic savings over investment. Foreign capital inflow implies a trade deficit or, more appropriately, a current account deficit.

A look at the evidence shows that the trade deficit has mirrored the development of the Federal budget deficit during the last decade. By reducing the Federal financing requirements, more funds would be available for domestic investment or a smaller net foreign capital inflow into the United States would be needed.

The key question is, how the reduction in the Federal deficit should be achieved: through tax increases or through spending restraint? Tax increases would further burden the U.S. private sector and would reduce its international competitiveness by imposing additional costs on workers and entrepreneurs. This would make it harder for Americans to compete in the international marketplace.

The preferred way to reduce the Federal deficit is therefore to enact spending cuts or, at the very least, a freezing of current spending levels.

It has also been argued that the trade deficit is mainly due to a surge in imports accompanying the strong U.S. expansion. Let me argue that depressed economic conditions abroad are at least as important. The record merchandise trade deficit of $58 million in 1983 was not primarily caused by a surge in U.S. imports. In fact, in 1983, U.S. imports of $258 billion were still below their peak of $261 billion registered in 1981. Since then, imports have grown to $280 billion.

A look at the export side reveals that exports are still below their peak of $234 billion in 1981. The export declines were concentrated in Latin America, where debt repayment problems and governmental austerity programs drastically curtailed import spending.

Cyclical and structural factors in other economies have therefore at least as much importance for the U.S. trade deficit as the cyclical situation in the United States alone.

This finding has important implications for trade and economic policy. Clearly, it would be inappropriate to artificially depress U.S. economic activity to hold down imports. Similarly, it would be improper to impose further artificial import barriers to reduce the level of U.S. imports below their natural level.

Instead, economic activity abroad needs to be rejuvenated and barriers to U.S. exports in other countries be reduced. Countries in a balance-of-payments surplus position, such as Japan, are particularly well placed to remove their import barriers. By this, they would not only contribute to a better balance in international payments, but also help to perpetuate the global recovery and benefit their own consumers.

It has been argued that U.S. interest rates are abnormally high and that they induce foreign capital inflows into the United States. I believe this argument is doubly flawed. First of all, interest rates have come down sharply from their peaks in 1981, while the trade deficit has mushroomed since then.

Second, foreign capital inflows into the United States peaked in late 1981 and have continued to decline since then.

Rather than attracting increasing amounts of foreign capital, the United States has been lending and investing less abroad. The U.S. capital outflow has been cut sharply from $118 billion in 1982 to $38 billion in 1983. Thus, the United States is not pulling in more foreign capital, but is keeping more funds at home.

Several observations are in order. First of all, the United States at the present time is the most vigorous major economy in the world. It is therefore natural that Americans invest their resources at home.

Second, deregulation—particularly in financial sectors—has provided new opportunities for domestic and foreign investors here that did not exist before.

Third, international lending by U.S. banks abroad has been curtailed sharply due to the increasing regulation of international banking activities, the debt service difficulties of many developing countries, and the depressed economic conditions abroad.

All these factors have combined to reduce total foreign lending by U.S. banks from $109 billion in 1982 to only $15 billion in 1983. As a consequence, the net foreign investment position of the United States is deteriorating rapidly. However, one clearly cannot have both a decreased U.S. bank exposure abroad and an increase in U.S. foreign assets in order to bolster the U.S. foreign investment position.

Exchange rates also clearly have an influence on the competitiveness of U.S. industry abroad. The current overvaluation of the dollar on fundamental grounds has made it more difficult for American firms to compete in foreign markets.

However, one should exercise caution in arguing that a depreciation of the dollar would immediately resolve all our trade problems. First of all, it would take 1 to 2 years before any change in the exchange rate would have a beneficial effect on the trade balance.

A depreciation of the dollar would also tend to make imported goods more expensive and might well rekindle inflationary forces in the U.S. economy.

Finally, while the dollar depreciation would bring the current account into balance, the international capital position of the United States would also be balanced. That is, we would no longer be able to finance part of the Federal deficit and our own investment from international sources and all the funds would have to be raised domestically. This might crowd out domestic investment more than now and lead not only to higher U.S. interest rates, but might also affect the U.S. recovery adversely.

Thus, under current circumstances, a substantial dollar depreciation might well turn out to be a mixed blessing. The best that one could hope for is a gradual decline of the real exchange value of the dollar that allows sufficient time for adjustment of the trade sector and a concommitant balancing of the Federal budget deficit.

One cannot close a discussion of our trade deficit problems without referring to the very large statistical discrepancy that has not only been characteristic of the U.S. balance-of-payments accounts, but also of the global balance of payments. It is important to keep these statistical problems in mind when one designs and implements policies that are intended to rectify an alleged imbalance that may not even exist in reality. For instance, in 1983, the statistical discrepancy in the U.S. balance of payments was $41 billion, and was by this almost as large as the merchandise trade deficit.

In summary, it is a very difficult task indeed to determine how much of the U.S. trade deficit is caused by cyclical factors on the one hand and by structural factors on the other hand. However, it is certain that structural factors do play a major role in the current trade imbalance. The mere passage of time and a more balanced cyclical economic situation alone will therefore not eliminate the trade deficit.

Structural adjustments are called for, both in this country and abroad. The thrust of these structural adjustment measures should be designed to eliminate existing structural imbalances, such as the Federal budget deficit, and to take steps to reduce or eliminate other barriers to adjustment, so that market forces can again play their proper role in bringing about equilibrium in the international accounts.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Heller follows:]

PREPARED STATEMENT OF H. ROBERT HELLER

Foreign Trade and the Balance of Payments:

Cyclical Adjustment, Structural Problem, or Policy Dilemma ?

The rapidly rising U.S. trade deficit has reached record levels in recent months. For the policy maker it is important to ascertain whether the trade deficits will be reversed automatically over the course of the business cycle or whether structural factors will lead to a continued worsening of the situation. These questions are important because they have a direct impact on the viability of the recovery and influence the range of options open to the policy makers.

Some observers blame the large U.S. trade deficit on the strength of the U.S. recovery and nigh U.S. interest rates. By this they stress the cyclical causes of the trade deficit. While these factors are certainly of some importance, they do not tell the whole story. A good argument can be made that structural influences are at least as important in causing the rising trade deficits. To focus exclusively on the predominantly cyclical factors will lead to an improper diagnosis of the problem and therefore to inappropriate policy prescriptions.

But before trying to pinpoint individual causes of the trade deficits, it is appropriate to consider the larger economic interrelationships between the trade imbalance, the governmental deficit, and the connection between domestic saving and investment. Changing any one of these parameters will have

important feedback effects on the other parameters. Therefore, only a broad framework that takes all the interrelationships into account will lead to the appropriate policy prescriptions.

It should also be borne in mind that while the trade imbalance has a physical or real dimension to it, it are the financial flows that provide much of the linkages and feedback effects important to an analysis of the trade deficit. In my remarks I will therefore focus mainly on the financial consequences of the trade imbalance.

1. The Federal Deficit and the Trade Deficit

It is useful to examine the relationship between the federal deficit and the trade deficit in a flow-of-funds framework. This accounting framework juxtaposes all sources of income in the American economy and the uses of the income earned. Americans derive their income from consumption expenditures by others, governmental spending, investment expenditures, and purchases by foreigners, that is, U.S. exports. They spend their income on consumption goods, taxes, saving, and imports. Obviously, expenditures on consumption by one group of people are equal to income earned by others from these consumption expenditures. This leaves the governmental sector, the saving-investment relationship, and the foreign sector to be considered.

The government deficit will have to be financed by a foreign

capital inflow or an excess of domestic saving over investment. Thus, the government deficit can be financed only by a crowding out of domestic investors, an increase in domestic saving, or an increase in net foreign capital inflows — which implies an increase in the trade deficit or, more appropriately, in the current account imbalance.

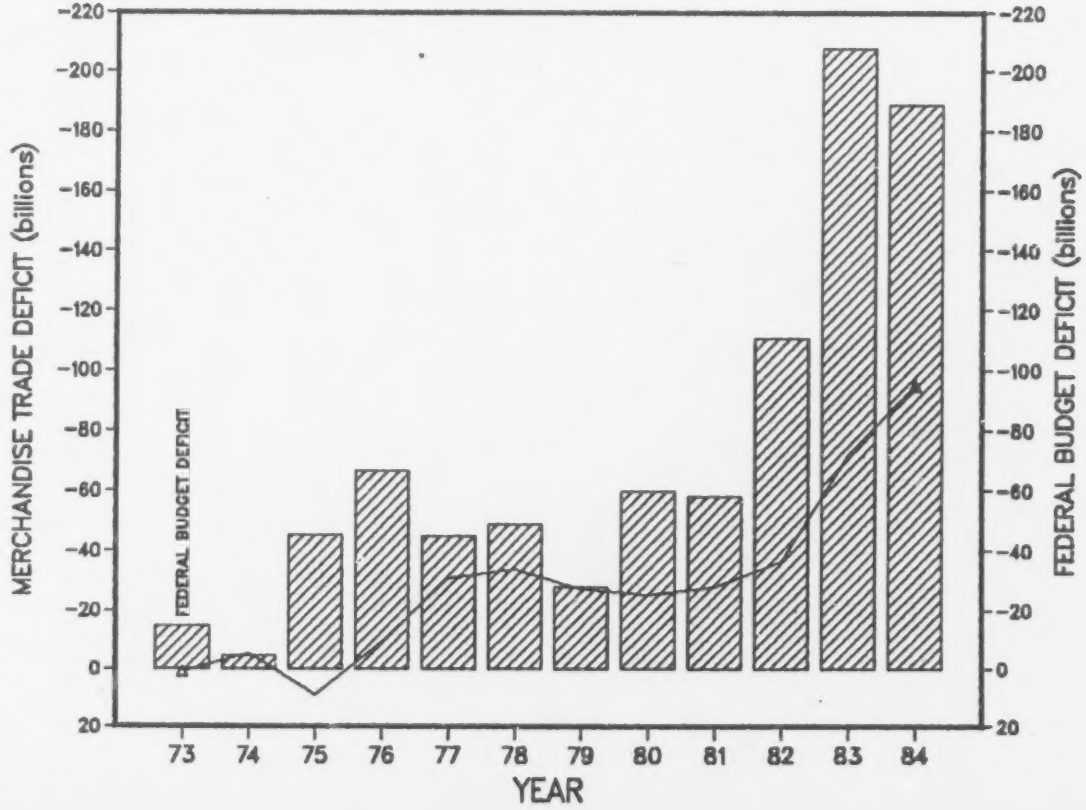
Figure 1 shows that the trade deficit has mirrored the development of the federal budget deficit during the last decade. If the trade deficit were eliminated somehow or other, say through a sharp depreciation of the dollar, it follows that foreign capital inflows would also be in balance and that the entire federal deficit would have to be financed from domestic sources. This undoubtedly would drive up domestic interest rates even further, a point to which I would like to return later.

In contrast, there is little doubt that a reduction in the federal deficit would help to reduce the trade deficit. By reducing the federal financing requirements, more funds would be available for domestic investment and/or a smaller net foreign capital inflow into the U.S. would be needed.

The key question is how the reduction in the federal deficit should be achieved: through tax increases or through spending restraint. Tax increases would further burden the U.S. private sector and reduce its international competitiveness by imposing additional costs on workers and entrepreneurs. This would make it

Figure 1

FEDERAL AND TRADE DEFICITS



harder for Americans to compete in the international marketplace.

The preferred way to reduce the federal deficit is therefore to enact spending cuts or, at the very least, a freezing of current spending levels. These actions will free domestic resources that can be used to create new jobs or to make old jobs more productive and competitive. This greater competitiveness will soon be reflected in more exports and the continuing economic expansion will reduce the need for governmental spending on unemployment and welfare programs. Everone would be better off.

Just like it has proven elusive to separate the cyclical and structural components of the federal budget deficit, a clear separation of cyclical and structural components of the trade deficit is also difficult to achieve. The relationship between the federal budget deficit and the trade deficit makes this abundantly clear.

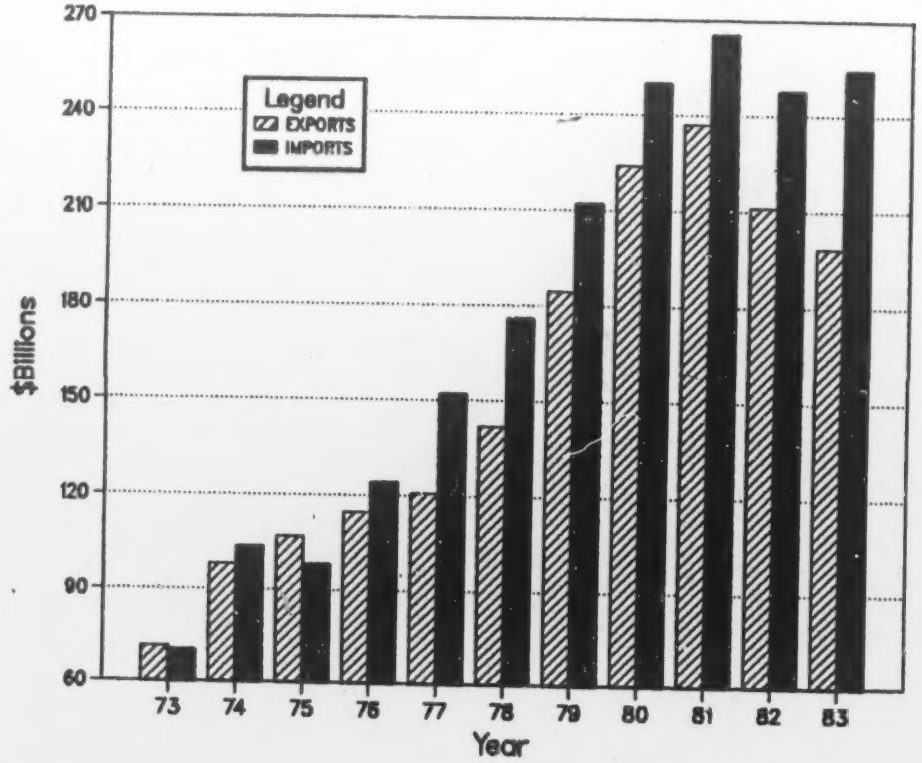
2. Economic Activity and the Trade Deficit

It has been argued that the trade deficit is mainly due to a surge in imports accompanying the strong U.S. expansion. This is questionable.

Figure 2 shows that the record merchandise trade deficit of $58 billion in 1983 was not primarily caused by a surge in U.S.

Figure 2

U.S. Merchandise Exports & Imports



Note: 1983 first three quarters at annual rates.

imports as the U.S. recovery got under way. In fact, in 1983 U.S. imports of $258 billion were below the peak of $261 billion registered in 1981.

Instead, the record trade deficit can be traced to a sharp decline in U.S. exports from their peak of $234 billion in 1981 to $201 billion in 1983. The export declines were concentrated in Latin America, where debt repayment problems and governmental austerity programs drastically curtailed import spending. U.S. exports to Latin America dropped by some 40 percent between 1981 and 1983. U.S. exports to the other industrialized countries have stagnated since 1980.

We may conclude that the depressed level of U.S. exports rather than a surge in U.S. imports is a key factor in explaining the trade deficit. Cyclical and structural factors in other economies have therefore at least as much impact on the U.S. trade deficit as the cyclical situation in the U.S. alone.

This finding has important implications for trade and economic policy. Clearly, it would be inappropriate to artificially depress U.S. economic activity to hold down imports. Similarly, it would be improper to impose further artificial import barriers to reduce the level of U.S. imports below their natural level.

Instead, economic activity abroad needs to be rejuvenated and barriers to U.S. exports in other countries be reduced. Countries

in a balance of payments surplus position, such as Japan with its $25 billion current account surplus, are particularly well placed to remove their import barriers. By this they would not only contribute to a better balance in international payments, but also help to perpetuate the global recovery and benefit their own consumers.

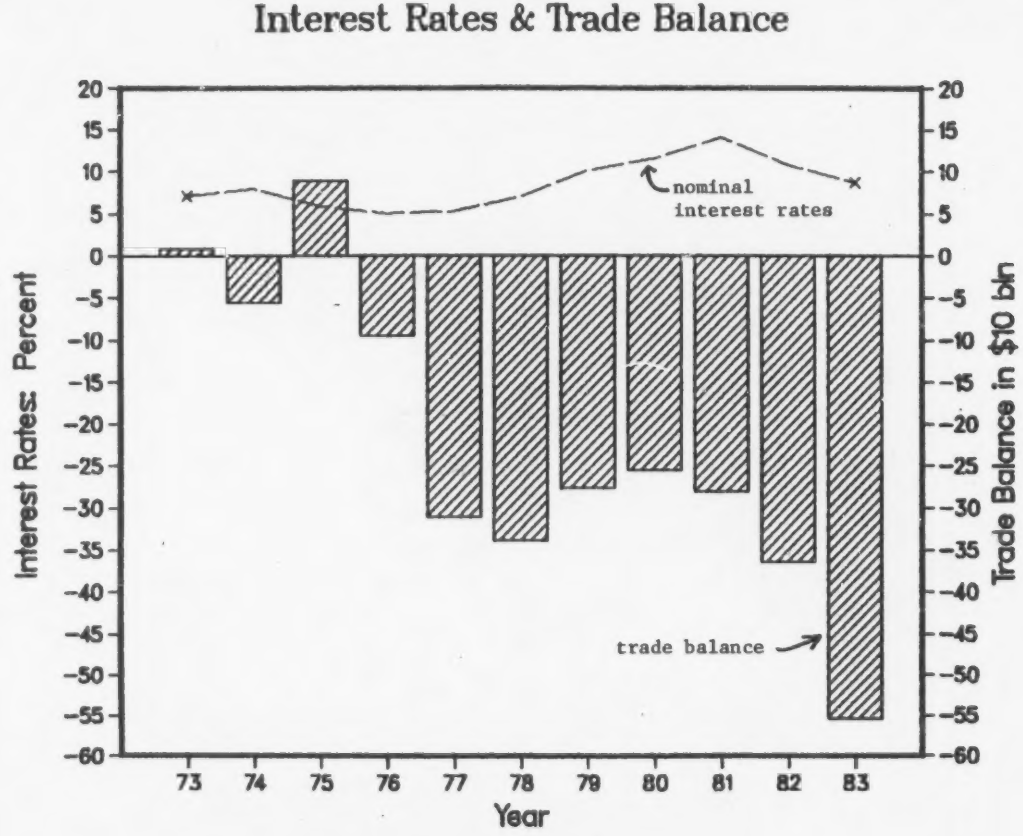
3. Interest Rates and the Trade Deficit

It has been argued that U.S. interest rates are abnormally high and that they induce foreign capital inflows into the United States. The argument continues that due to the arithmetic of double-entry bookkeeping, the capital account surplus has to be balanced by a deficit in the current and trade accounts.

While theoretically conceivable, this argument is doubly flawed on empirical grounds. First of all, as Figure 3 shows, interest rates have come down sharply from their peaks in 1981, while the trade deficit has mushroomed since then. Also in prior years it is difficult to discern a systematic relationship between interest rates and the trade deficit.

Second, foreign capital inflows into the U.S. peaked in late 1981 and continued to decline in 1983 from their 1982 levels. For instance, in the first three quarters of 1983, foreign capital inflows into the U.S. were running at an annual rate of $61 billion, which was considerably below their 1982 level of $88 billion.

Figure 3



Note: 1983 first three quarters at annual rates.

Rather than attracting increasing amounts of foreign capital, the United States has been lending and investing less abroad. The U.S. capital outflow has been cut sharply from $118 billion in 1982 to $38 billion in 1983 (first three quarters at annual rate). The U.S. is not pulling in more foreign capital, but is keeping more funds at home.

Some observers have deplored this tendency and have argued that the United States stands to become a net debtor nation to the rest of the world. This is considered undesirable both on the ground that it will impose additional debt service burdens on the U.S. economy and that it is inappropriate for one of the wealthiest countries in the world to be a net user of foreign capital. Clearly, both arguments cannot be right at the same time. If foreign debt always constitutes a net burden, poor countries are obviously not better placed to carry this burden than rich countries. It is therefore appropriate to examine these points in some greater detail.

4. International Indebtedness and the Trade Deficit

At the end of 1982, the United States had $834 billion in foreign assets and foreigners had invested $666 billion in the United States, for a net investment position of $168 billion in favor of the United States. By the end of 1983, this net investment

position had eroded to approximately $125 billion, and it became clear that by the end of 1985 the U.S. net international investment position might erode to zero, if current trends continue.

Several observations are in order. First of all, the United States is at the present time the most vigorous major economy in the world. It is therefore natural that Americans invest their resources at home and that foreign funds flow into the U.S. in order to benefit from and to participate in the economic resurgence under way here. A cyclical investment boom is now gathering strength.

Second, the deregulation of large sectors of the American economy has provided new opportunities for domestic and foreign investors that did not exist before. Consequently, more American capital is staying at home and foreign capital is being invested here for strategic and structural reasons.

The financial sector in particular has benefited from the deregulation process still under way. Foreign banks see new opportunities in the United States, and American financial institutions are eager to broaden the geographic and product diversification of their financial services.

•

Third, international lending by U.S. banks abroad has been curtailed sharply due to the increasing regulation of

international banking activities, the debt service difficulties of many developing countries, and the depressed economic conditions abroad.

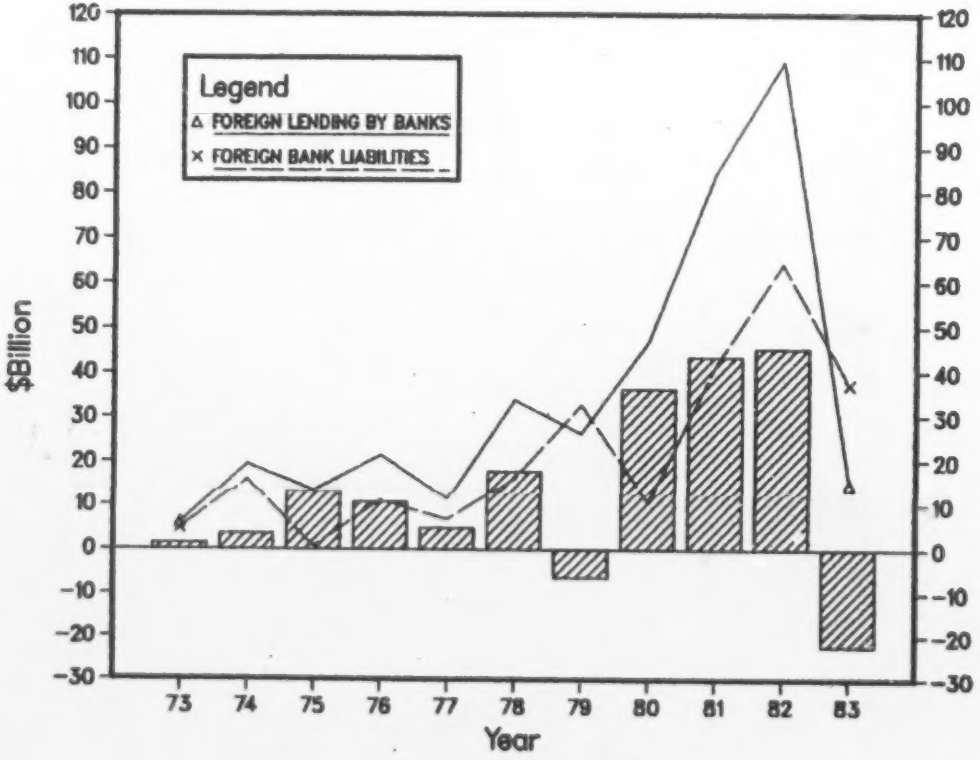
All these factors have combined to reduce total foreign lending by U.S. banks from $109 billion in 1982 to $15 billion in 1983 (first three quarters at annual rate) as shown in Figure 4. While U.S. bank lending abroad used to contribute greatly to the enhancement of the net U.S. international investment position, this situation has been reversed in 1983, with U.S. based banks sharply curtailing their international lending activity.

As a consequence, the net foreign investment position of the United States is deteriorating rapidly. However, one cannot have both a decreased U.S. bank exposure abroad and an increase in U.S. foreign assets in order to bolster the U.S. foreign investment position. Any action taken to reduce U.S. bank exposures abroad will -- pari passu — reduce the U.S. foreign investment position.

It would be difficult indeed to discern whether the slowdown in foreign lending by U.S. banks is mainly due to cyclical or structural reasons. Undoubtedly, both play a role. The cyclical strength of the U.S. economy makes more money stay at home, and the lack of a strong resurgence of the world economy also contributes. But the structural factors mentioned, such as new U.S. legislation and regulatory requirements, and the severe

Figure 4

Net Foreign Bank Lending



Note: 1983 first three quarters at annual rates.

structural adjustment problems faced by many foreign countries undoubtedly also have an important impact on U.S. bank lending abroad and by this on the U.S. balance of payments situation in general.

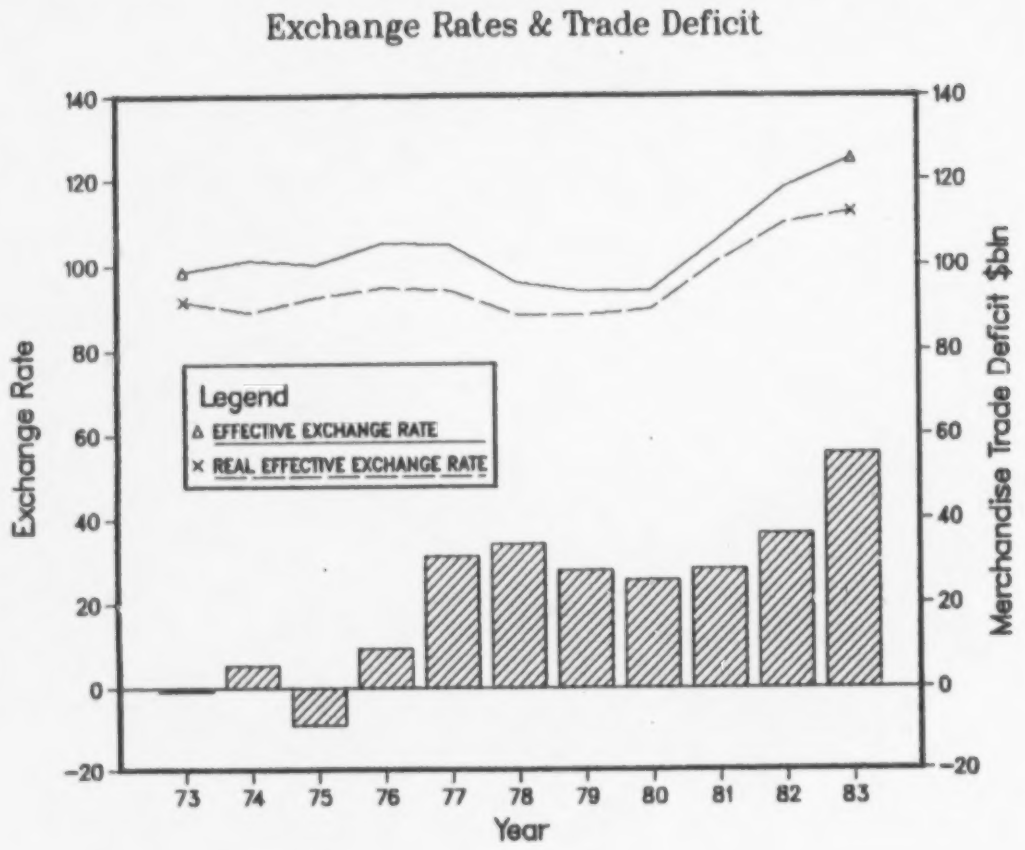
5. Exchange Rates and the Trade Deficit

Exchange rates clearly do have an influence on the competitiveness of U.S. industry abroad. The current overvaluation of the dollar on fundamental grounds has made it more difficult for American firms to compete in foreign markets.

In 1978-80, the value of the dollar reached a low point as shown in Figure 5. This is true for both the trade-weighted and the real effective exchange rate, which takes into consideration not only multilateral exchange rate movements, but also the impact of differential inflation rates among nations. In 1980, the U.S. merchandise trade deficit amounted to $28 billion. Since then, the dollar has appreciated and the trade deficit has increased. This evidence points to a significant relationship between the exchange rate and the trade balance due to the influence of the exchange rate on the competitive position of the United States.

However, one should exercise caution in arguing that a depreciation of the dollar would immediately resolve all our trade problems. First of all, it would take one to two years before any

Figure 5



Δ Base Year = 1975

X Base Year = 1980-82

change in the exchange rate would have a beneficial effect on the trade balance. Due to the familiar J-curve effect, payments for our imports would soar as each dollar would buy less and less foreign goods and the trade balance would deteriorate until the improved export competitiveness would begin to turn the balance.

Second, a depreciation of the dollar would tend to make imported goods more expensive and might well rekindle inflationary forces in the U.S. economy.

Third, as the dollar depreciation would bring the current account into balance, the international capital position of the U.S. would also be balanced. That is, we would no longer be able to finance part of the federal budget deficit from international sources and all the funds would have to be raised domestically. This might crowd out domestic investment more than now and lead not only to higher U.S. interest rates, but might also affect the U.S. recovery adversely.

We may conclude that under current circumstances a substantial dollar depreciation might well turn out to be a mixed blessing. The best that one might hope for is a gradual decline of the real exchange value of the dollar that allows sufficient time for adjustment of the trade sector and a concommittant balancing of the federal budget deficit.

6. Accounting Errors and the Trade Deficit

One cannot close a discussion of our trade deficit problems without referring to the very large statistical discrepancy that has not only been characteristic of the U.S. balance of payments accounts, but also of the global balance of payments. In 1983, the statistical discrepancy in the U.S. balance of payments was $41 billion, and was by this almost as large as the merchandise trade deficit.

There is some reason to believe that the bulk of the unrecorded transactions is due to an underrecording of receipts of service items such as reinvested earnings abroad, investment income, and fees. Consequently, the U.S. current account deficit, if measured properly, is likely to have been substantially smaller than indicated by the officially reported data. Thus it is entirely possible that the U.S. was in substantial current account surplus in 1983.

It is important to keep these statistical problems in mind when one designes and implements policies that are intended to rectify an alleged imbalance that may in fact not even exist. Such misguided policy actions might do more damage than good. Consequently, it is important to proceed with circumspection and caution in this area due to the large uncertainties affecting the data that present the basis of the analysis.

7. Conclusions

In summary, it is a very difficult task indeed to determine how much of the U.S. trade deficit is caused by cyclical factors on the one hand and by structual factors on the other hand. However, it is certain that structural factors do play a major role in the current trade imbalance. The mere passage of time and a more balanced cyclical economic situation alone will therefore not eliminate the trade deficit.

First of all, there exists a direct link between the size of the federal budget deficit and the international balance of payments. The high federal financing requirements are directly reflected in high and rising trade and current account deficits. To the extent that the federal deficits are structural in nature, the trade deficits have a structural component as well.

Second, the U.S. trade deficit is not primarily due to a surge in U.S. imports accompanying the U.S. recovery, but due to a fall in U.S. exports. Actions designed to stimulate economic recovery abroad and to remove existing trade barriers to U.S. goods are preferable to further U.S. import restrictions intended to rectify the trade imbalance. That is, policy actions designed to eliminate existing structural barriers are indicated.

Third, it is not true that high U.S. interest rates have led to a surge of foreign capital inflows into the United States. Instead,

the positive balance on capital account is primarily due to a sharp curtailment of U.S. bank lending abroad. This slowdown in bank lending undoubtedly has both structural and cyclical components.

Fourth, while many observers wish to see a further increase in the net U.S. international investment position abroad, it is not possible to achieve this goal when at the same time U.S. lending abroad is being discouraged and curtailed. One cannot have an increase in foreign assets and a decrease in international exposure at the same time.

Fifth, the current overvaluation of the U.S. dollar has hurt the competitiveness of American exporters. However, little can be gained by a sharp and precipitous drop in the exchange rate. Instead, a gradual and smooth exchange rate adjustment is to be preferred.

Sixth, the U.S. balance of payments statistics are subject to very large statistical discrepancies and reporting errors. Caution is therefore needed in the design of policy measures based on the reported data.

Overall, we may conclude that there is little reason to believe that a better cyclical constellation of the various economies would significantly curtail or even eliminate the U.S. trade deficit. Instead, structural adjustment measures are called for

both in this country and abroad. The thrust of these structural adjustment measures should be designed to eliminate existing structural imbalances, such as the federal budget deficit; and to take steps to reduce or eliminate other barriers to adjustment, so that market forces can again play their proper role in bringing about equilibrium in the international accounts.

Senator JEPSEN. Thank you, Mr. Heller.

I would ask Mr. Tumlir the same question that I did Mr. Sprinkel and that is, do you feel that there's enough worldwide concern about agricultural trade to gain international commitment to lessen the trade tensions in this sector?

Mr. TUMLIR. Yes. I believe that's a very important part of international trade, and of the negotiations about international trade, and that it represents the core of the difficulty in international trade policy. Obviously, there are differences in attitude to this question. I am now beginning to feel optimistic as to the possibility of constructive solutions in this area because a number of governments are facing very significant problems in it, especially on the side of finance. It is becoming obvious to them that this mutual subsidization, or subsidy wars, are self-canceling and they do not have good results and they cost governments more and more money. So I hope that both the budget considerations and the insight into the difficulty of the trade policy will make possible more liberal attitudes.

Senator JEPSEN. Are you opposed to bilateral agreements even if they are trade liberalizing such as the proposed United States-Israel free trade agreements? Should we seek an international discussion of the types of bilateral agreements that do not undermine GATT?

Mr. TUMLIR. Yes. Bilateral agreements are by definition discriminatory and the United States has accepted certain obligations under GATT, such as article I of GATT, which pledges all members of GATT to the principle. So I think when it comes to special arrangements between any two countries, unless they amount to full-scale customs union which is again provided as an exception to article I by article XXIV—by that we mean that these two countries become for all practical purposes a single customs area. Anything short of that falls outside GATT.

Senator JEPSEN. You're very obviously concerned about quantitative trade restrictions and I share your concern. But for the record, would you specifically give just an example of a quantitative trade restriction?

Mr. TUMLIR. Japan's agreement to limit the exports of automobiles to the United States to 1.68 million units in the years 1981 through 1983 and the subsequent agreement to limit them to 1.85 million units for 1984.

Senator JEPSEN. Would you speculate on loss of the economic growth caused by these restraints?

Mr. TUMLIR. Speculate is a good word. If I wanted to be evasive, I would say it was one element among others that brought down the growth rates from their very high levels in the 1970's. Inflation was another one and Federal regulations was perhaps another element. But I don't want to be evasive.

I think that protectionism was closely connected with all these other causes. In other words, I believe it was one of the main elements accounting for the decline in the growth rates from the 1950's and 1960's. In those decades, the aggregate growth rate of the world economy was about 6 percent a year, but in the industrial economies of the OECD group, it was closer to 5 percent, and for the U.S. economy, it was close to 4 percent. I think that the impairment of the price system through these protectionist measures was what brought the growth

rates down to their present range of 0–3 percent, and I'd like to make one other point.

The cost of protection in terms of growth is very well known when protection is by means of a tariff. Tariff, as I said, does not impair the price system; it's merely a wedge between internal prices and external prices and once the economy is adjusted to a tariff, it can operate as before. Tariff does not impair its growth potential very much. But the cost of protection by quantitative measures, the cost in terms of growth, increases through time. It becomes heavier and heavier; it accumulates.

Senator JEPSEN. I thank you.

Mr. Heller, you indicate that the U.S. trade deficit is not primarily due to a surge of imports but due to a fall in exports. Is that accurate?

Mr. HELLER. That's right, Mr. Chairman, except during the last few months of this year. I was talking about 1983. During the last few months of this year, imports have continued to surge and exports are still rather depressed.

So I think what you're saying—yes, that's an accurate description for 1982 and 1983 as the trade gap opened up. As we proceed from here into the future, it becomes less and less true.

Senator JEPSEN. Well, although imports in 1983 were below the 1981 level, is it not true that this masks a substantial decline in oil imports because of the falling oil prices and a large cyclical increase in other imports? Is that an accurate statement?

Mr. HELLER. I think it's an accurate statement. Our imports of oil certainly were down and oil prices were slightly down as well. That meant more room was left for other commodities. I think it's always difficult to argue commodity by commodity in that particular area.

Senator JEPSEN. Well, I appreciate your reluctance to wait for a cyclical adjustment to lower the trade deficit, but in looking at imports changes by category, isn't it possible that the value of imports will decline as the economy settles down to a more sustainable growth?

Mr. HELLER. As our growth rate slows down a bit, and especially as the first phase of stock building is past, that surge in imports will also go down. I agree with you there.

On the other hand, import prices are likely to increase again more sharply than they have been during the last few years because we had tremendous excess capacity in most of the key raw materials. As world industry picks up, there may be a danger that prices in the raw materials will pick up and therefore also the price of imports will pick up. So as far as value of imports is concerned, I don't see much reduction in the growth rate there. As far as the volume is concerned, I think we can argue about that.

Senator JEPSEN. You stated essentially that the current overvaluation of the U.S. dollar has hurt the competitiveness of American exports. However, little can be gained by a sharp drop in the exchange rate. Instead, you recommend a gradual exchange rate adjustment is to be preferred. Is that correct?

Mr. HELLER. That's right, sir.

Senator JEPSEN. Talk about the mechanics for the record, will you, please, of a gradual exchange rate adjustment.

Mr. HELLER. Well, the mechanics are rather difficult; at the same time they are very, very simple. For instance, we should stay away from precipitous action designed to push down the U.S. dollar in foreign exchange markets. For instance, the Federal Reserve should undertake no large-scale direct intervention that would push the dollar down. The Secretary of the Treasury shouldn't give speeches that he feels the U.S. dollar is overvalued and as a result foreigners would run out of U.S. dollars as has happened in years past. That kind of action I would avoid.

Instead, what you're hoping for is a smooth and gradual adjustment. You don't always get that type of smooth and gradual adjustment because exchange markets sometimes react.

Senator JEPSEN. What are the ingredients of a smooth and stable adjustment? What are the characteristics? How do you describe them? What's the makeup? What would be the perfect solution for that to happen?

Mr. HELLER. The perfect solution would be a slow drift downward in the exchange rate of the U.S. dollar by 15 to 20 percent roughly in that neighborhood, and then after that maintain stability against the other key currencies in the world. Basically, I believe, Mr. Chairman, that the U.S. dollar has again rejoined the hard currencies of the world because the U.S. inflation rate has come down so sharply. Our inflation rate is roughly comparable to that of Japan, Germany, Switzerland, and other key currency countries in the world. What we are suffering from right now is a one-time overvaluation of the U.S. dollar that calls for a one-time correction and not a free fall of the dollar in a downward direction.

Senator JEPSEN. Well, I must pursue this a bit more. What ingredients are necessary for that correction to take place? Is it taking place now, in your opinion?

Mr. HELLER. I think it is taking place.

Senator JEPSEN. Why is it taking place?

Mr. HELLER. Because the markets perceive that the large U.S. trade deficit will eventually have to be corrected. So over a period of years, we will see a reduction in those trade deficits and the one way in which you bring about that reduction in the trade deficit is by a declining exchange rate of the U.S. dollar, making U.S. industry and agriculture more competitive in world markets again.

Senator JEPSEN. That's what I was looking for, some specifics. U.S. agriculture is one thing that must become more competitive in world markets, and how can that be brought about?

Mr. HELLER. It would automatically become more competitive as the value of the U.S. dollar would drop slightly compared to those of our key trading partners. If the value of the dollar would be 10 to 20 percent lower than it is right now, that means that the prices in world markets for U.S. agricultural commodities would drop as well. But as both Mr. Tumlir and Secretary Sprinkel have pointed out, the quantitative restrictions that are being faced by some of these exporters in other countries, they also need to be removed, and I think that's an important direction to work in. I think that a basic principle that one may nail on the masthead there is that no country should subsidize an industry where they're net exporters. In agriculture as well as in other industries, you see countries subsidizing commodities where

they are net exporters, and I think that is the key problem that other countries then have to face.

Senator JEPSEN. In Japan, which is not a net exporter of red meat, what role does the Government play with regard to Japan's red meat situation?

Mr. HELLER. Well, basically they have a system of both quotas as well as tariff charges that result in very, very high meat prices. If you walk into a supermarket or a small store in Japan, you would be paying anywhere from $15 to maybe up to $20 per pound of steak. So it's a highly protected industry that clearly doesn't yield any export opportunities for U.S. producers of agricultural products.

Senator JEPSEN. In the foreign exchange adjustment one that will happen naturally or must policy help it along?

Mr. HELLER. Well, one should certainly encourage adjustment by those countries that maybe don't have as free an exchange market as one would like to see. Secretary Sprinkel has talked about the opening up of the Japanese capital markets and that would certainly be very helpful in that respect. If one looks at the Japanese exchange rate, it tends to move in steps that are more reminiscent of the days of flexible but adjustable par values, judging just from the pictures that the foreign exchange plots yield over time.

I think more flexibility, more market orientation of exchange rates would certainly be helpful, although I recognize the point Mr. Tumlir brought up that the foreign exchange markets alone cannot take all the pressure.

Senator JEPSEN. Would a reduction in trade barriers as a policy change help?

Mr. HELLER. Of course, very much, Mr. Chairman. And again, I think that the reduction in trade barriers should be undertaken mainly by those countries that are currently in a position to do so, that is, the countries that are running large current account surpluses. Those countries are clearly in a position from a political standpoint to liberalize their foreign markets as they're running these large surpluses, and they would also contribute to the rejuvenation of the world economy, especially as far as the developing countries are concerned.

Senator JEPSEN. I gather from your statement that you indicate it's not true that high U.S. interest rates have led to a surge of foreign capital flows into the United States; rather, the gain in net foreign capital flow is a result of a sharp curtailment of U.S. bank lending abroad.

Would you elaborate on that? Why would the foreign capital flow increase as a result of a sharp curtailment of U.S. bank lending abroad?

Mr. HELLER. Well, Mr. Chairman, in past years, there was roughly a balance as far as money coming into the U.S. banking system through foreign deposits and foreign lending by U.S. banks is concerned. If you want to go into detail, actually you may want to segregate the different groups of banks in that particular picture. If you look at the foreign banks operating in the United States, they were using the United States as a funding base, so they were pulling more funds out of the United States than they were attracting in foreign deposits. The smaller banks in the United States did not benefit from any deposits from abroad and they were tending to be net lenders.

If you look at the money center banks in the United States, they were basically lending less abroad than they were taking in, in new deposits, because foreigners were always very attracted by these U.S. banks and they were putting a lot of funds into them.

On a net balance, there was a slight outflow of capital by U.S. banks into other countries.

Now in 1983, that situation changed drastically. American banks invested very, very little—about $15 billion—during 1983 in foreign countries in the form of new lending. That was down from over $100 billion in 1982. The foreign capital inflows continued, but we are not putting any capital out anymore. That's why the shift in that net foreign lending position has come about, largely due to reduced lending by American banks abroad. The reasons, as I pointed out before, are: First, the depressed economic conditions abroad; second, the debt service difficulties which many countries have already; and third, the increasing regulation of international banking activity abroad.

Senator JEPSEN. Now if I might ask a followup to that then, are you implying that the banks must increase exposures to LDC's further so that they can buy our exports to lower the trade deficit?

Mr. HELLER. I think that's a very tough question. The banks are clearly reluctant to increase their exposures to countries that already have debt service difficulties.

What has also happened in the process of rescheduling agreements is that many of the trade credit lines that banks have made available to countries were essentially frozen because the 90-day trade credits were rescheduled over a 5-to-7-year period, depending on what particular country you're talking about. As a result, a bank now has as much exposure as it may want to have to a particular given country.

Now the problem is, how to get trade moving again? That new trade clearly calls for new trade credit and, in that sense, it is essential that American banks will make new credit lines available.

On the other hand, the regulators say, "Hey, be careful, don't increase your exposure to countries that are in difficulties."

Senator JEPSEN. I'm afraid what I'm hearing here is that the previous pattern of bank lending and LDC borrowing was offsetting a deterioration in our trade position because of growing trade restraints. Is that possible? Isn't that true?

Mr. HELLER. Well, clearly, past bank lending was financing the U.S. exports. Every U.S. agricultural and industrial export that moves abroad moves abroad initially with a trade credit attached to it.

Senator JEPSEN. So this great internationalization for agriculture which we experienced in the 1970's possibly was just not totally due to the sudden demand and awakening or realization of better diets and nutrition or whatever. It was possible that the bank lending and the LDC borrowing just happened to fit. Mr. Tumlir?

Mr. TUMLIR. I don't believe so, Senator. Our agricultural exports have been at least in most part to the new industrializing countries in Asia and so on. Brazil was essentially a food exporter herelf. Argentina was a food exporter.

Senator JEPSEN. Mr. Heller said that South America and so on——

Mr. TUMLIR. I think they are cutting imports from us that became necessary, and it affected the total export of the United States.

Senator JEPSEN. It was very largely due to the credit problems, wasn't it?

Mr. TUMLIR. Yes. It was not that any agricultural exporter suffered from Brazil. Argentina, or Mexico not importing from the United States. They have been importing essentially industrial products.

Mr. HELLER. That's right, Mr. Chairman. Most of our agricultural exports tend to move to countries like Japan, Korea, Taiwan, the Asian countries in particular, that are resource poor, that don't have any agricultural base, and so there's a lot of trading going on that way. The Latin American countries have been relying mainly on the intermediate industrial goods inputs into the industrial process.

Senator JEPSEN. But the trade they have been making, a lot of it has been due to the—or the decrease in it now is directly related—is this an accurate statement—directly related to the tightening of the bank lending to those countries?

Mr. TUMLIR. That is true, Senator, but I don't know whether exporting on uncollectible credit would be worth something and should be advocated.

Senator JEPSEN. I am not advocating anything. I'm trying to get into the record what this testimony in this hearing is about and that is to try to have a better understanding of the problem and separate the facts from the fiction and also tell it like it is.

Did the grain embargo—what happened to our agricultural exports after we went from $7 billion in exports in 1971 to $43 billion in 1981 in a 10-year period and they are now about $34 or $35 billion. Did the grain embargo have an impact on it?

Mr. HELLER. Well, certainly the embargos will always hold exports below the potential level. But overall, I would argue that agriculture has been one of the success stories of American business. In agriculture, we're running a very large trade surplus versus the rest of the world, and if the rest of the U.S. economy would be doing as well as agriculture, we would all be better off.

Senator JEPSEN. I should take you out to my State and travel with me.

Mr. HELLER. I must go there.

Senator JEPSEN. Certainly, the record shows that there was an explosion in the 1970's in the internationalization of agriculture. There's no question about it.

Do either of you have any closing statements for the record on how to solve our problem in trade deficits with a one-liner?

Mr. HELLER. Well, let me try a two-liner. One, we clearly need to work on the freeing of international markets abroad. That's where most of the restrictions are, in other countries, not in this country.

Senator JEPSEN. That's a must.

Mr. HELLER. That's an absolute must, and Secretary Sprinkel's travels to Japan are really enormously helpful that way. I know these have been very difficult negotiations and I think he, along with the other people in the administration, should be commended for continuing to pressure for liberalization over there.

And I think the other important thing is: Don't increase taxes in this country in order to eliminate a trade imbalance, either direct taxes in the form of import surcharges or taxes designed to reduce the Federal deficit. It's much more productive to work on the reduction in spending because increased taxes would just make American producers less competitive abroad.

Senator JEPSEN. Do you suggest we negotiate with these customers by using the big stick, like passing domestic content as some advocate?

Mr. HELLER. Well, that's a tough question. Sometimes the carrot works and sometimes the stick works. I hope that the carrot would be a more appropriate solution, especially as far as our allies are concerned. I find it always a difficult proposition to increase our own barriers just to have something to negotiate down from.

Senator JEPSEN. I noticed your first liner. You said that we've got to take out all restrictions from all of our customers. We have to get those barriers down. Are we going to help bring those barriers down by putting ours up?

Mr. HELLER. I don't see it, Mr. Chairman.

Senator JEPSEN. I don't, either, but I wanted to make sure that you really feel that way. I'm not trying to put words in your mouth.

Mr. HELLER. No. That's right.

Senator JEPSEN. Mr. Tumlir.

Mr. TUMLIR. I would just second what Mr. Heller said about both things. I would add that we should not perhaps worry too much about the deficit as such and about the exchange rate of the dollar. Frankly, when I hear about the overvaluation of the dollar, I get uneasy. I was living in Switzerland in that period of monetary turbulence. Until 1970, the dollar was buying 4.33 Swiss francs. By the end of 1979, it dropped to 1.37 and everybody was saying that this is a terrible undervaluation, terrible misalignment of purchasing power parities. Now it buys 2.20 Swiss francs. I personally do not know whether it has just corrected what was an undervaluation or whether it is undercorrected or overcorrected, and I don't think that anybody can know.

Senator JEPSEN. Do you have one or two lines for how to correct the trade deficit?

Mr. TUMLIR. I said, don't worry about it.

Senator JEPSEN. OK. Well, that's good to have on the record. We have kind of the spectrum of specifics and I appreciate your testimony and your taking your time. It was most interesting, educational, and you have been very helpful as we wrestle with this problem and I hope we execute intelligent, perceptive action on it.

I thank you both for attending and I wish you a safe journey home.

This meeting is adjourned.

[Whereupon, at 12:05 p.m., the committee adjourned, subject to the call of the Chair.]

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